Institutional shareholder monitoring as safe harbor for corporate governance?

van der Elst, C.F.

Published in:
Corporate Governance - New Experiences

Publication date:
2012

Document Version
Publisher's PDF, also known as Version of record

UNIVERSITY OF ZAGREB
Faculty of Economics & Business
ZAGREB - CROATIA

1st International Conference

CORPORATE GOVERNANCE – NEW EXPERIENCES: IMPLEMENTATION IN SOUTH EASTERN EUROPE

Proceedings

Zagreb, 2012

UNIVERSITY OF ZAGREB

Faculty of Economics & Business

ZAGREB - CROATIA

Jean Monnet Chair

Under the patronage of the President of Republic of Croatia Dr. sc. Ivo Josipović

1st International Conference

Corporate governance – new experiences: Implementation in South Eastern Europe

PROCEEDINGS

03 – 04 November 2011

Zagreb – Croatia

Publisher:

University of Zagreb
Faculty of Economics & Business
J. F. Kennedy 6
10000 Zagreb, Croatia

For the Publisher:

Professor Tonći Lazibat, Ph.D
Dean

Editor:

Professor Hana Horak, Ph.D
Jean Monnet Chair

ISBN 13:978-953-6025-53-4

Zagreb, 2012.

Official Sponsors

Foreword

Dear readers,

The 1st International Conference "Corporate Governance - new experiences: Implementation in South Eastern Europe" was held on 3rd and 4th November 2011 in Zagreb, Croatia. The conference was organized by the Faculty of Economics and Business in Zagreb under the high auspices of the President of the Republic of Croatia Prof. dr. sc . Ivo Josipovic. Professor Hana Horak, the chairperson of the Conference Program Committee, has assembled a number of participants researchers and practitioners from the European Union (Germany, France, Great Britain, Poland, Belgium, Slovenia), as well as from the countries of Southeast Europe and the United States. Conference participants were numerous Croatian experts in law and economics, attorneys, civil servants from the administration bodies, representatives of the state owned companies, representatives of independent agencies, courts and other bodies, undergraduate and postgraduate students. At the opening of the conference Professor Nevenka Čavlek, vice dean of the Faculty of Economics, addressed the participants on behalf of the host, followed by Professor Boris Cota on behalf of the Croatian President, mr.sc. Andrej Plenković, State Secretary for the European Integrations and His Excellency Mr. Jerome Pasquier, French ambassador to Croatia.

In her presentation professor Horak pointed out that the purpose and objective of the conference were to contribute to the development and implementation of corporate governance in Southeast Europe, particularly Croatia, bearing in mind that the transparent corporate governance is highly important for the stability of financial markets and sustainable economic growth, as well in the South East Europe, as in the European Union and the World Economy.

During the two-days conference was given an overview of developments in corporate governance in Europe and worldwide. After introductory remarks delivered by Ms. Hargitai, EBRD Director for Croatia, the presentations of the European, US and Asian corporate governance experts took place.

The second day of the conference was dedicated to display of achievements in corporate governance, in the areas of the efficiency of the company's management, remuneration and independence of members of supervisory and management boards, corporate governance in state owned companies and importance of accounting and auditing issues in corporate governance.

All these topics are the subject of numerous studies and contribute to the development of corporate governance in general.

When the corporate governance becomes transparent it helps in preventing corruption and attracts entrepreneurs and investors. Successful corporate governance in the public sector and in the state owned companies is an essential precondition for the creation of competitive economy. Distinguishing characteristics of the good corporate governance are: transparency, disentangling of the corruption, respect of the rule of law, market orientation, both in private and public network, or a mixture of both. This conference sends a message about the importance of transparency and accountability as a precondition for strengthening the economy and creating new opportunities. It should be noted that the core values of good corporate governance are the same as the core values of democracy and policy.

This conference proceeding is an important contribution to the development of corporate governance in the Republic of Croatia and in the countries of the region and also the opportunity for implementation of the new experiences and harmonization of the best practices in corporate governance.

Professor Tonći Lazibat, Ph.D
Dean

Professor Hana Horak, Ph.D
Jean Monnet Chair

Table of Contents

Review
UDC 347.72.031:005.7>(4-67 EU)

Christoph Van der Elst

INSTITUTIONALISED SHAREHOLDER MONITORING AS SAFE HARBOR FOR CORPORATE GOVERNANCE?

INTRODUCTION: THE POSITION OF (THE GENERAL MEETING OF) SHAREHOLDERS

An efficient division of power between the board of directors and shareholders of the company is quintessential to equilibrate the board's responsibility to take discretionary business decisions and the shareholders rights to monitor board's behavior.

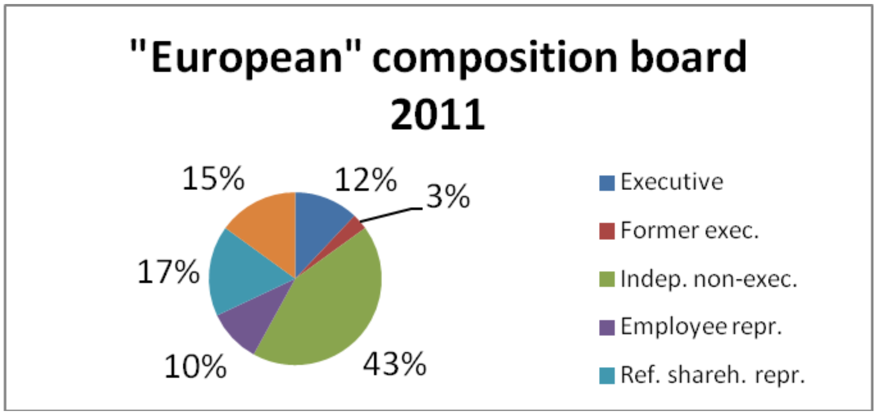
Until the mid or late 20th century the general meeting was considered the supreme body of the company. The German Law on Stock Companies of 1937 was among the first to shift the residual power to the board of directors and restrict the power of the general meeting of shareholders to those explicitly reserved in the companies act. In Italy the shift of power took place in 1942 when the new Civil Code was issued. The general meeting of shareholders was assigned the supervisory function and could only interfere in the cases the articles of association provided the meeting this power or it was required by the board of directors. In 2003 this approach was confirmed. According to article L.225-35 of the French Commercial Code the board of directors has the decisive power to determine the strategy of the company and the implementation of the strategic policies. The board is also empowered to take every decision enhancing the proper functioning of the company and settling the corporate business. The powers of the French general meeting are limited to those identified in the Commercial Code. The French Cour the Cassation already decided in 1946 for this type of board supremacy.[1] The Dutch Hoge Raad developed a similar reasoning rejecting the share buy back decision of the general meeting of the Dutch Forum-bank NV in 1953.[2] The Court argued that the general meeting holds only those competences which are granted in the articles of association and by the law and that the decision to buy back the shares is an exclusive competence of the board. In Belgium the legislator only changed the supremacy of the general meeting of shareholders in the supremacy of the board of directors in 1973 when it transposed the first European Company Law Directive. The following decades the monitoring powers of the shareholders were limited and discretionary powers of directors were *de facto* infinite.

When corporate governance became fashionable in the nineties, spurred in light of UK corporate debacles, the newly issued corporate governance codes, accompanied with strong regulators' support, stressed the importance of balanced boards with non-executive directors and independent board members, emphasized the separation of the role of CEO and chairman of the board and supported the establishment of board committees and risk management systems, rather than returning power to shareholders. A number of these corporate governance features were embedded in corporate law. In the Belgian Companies Act the conditions to be elected as an independent director was inserted and the audit committee was granted a specific task to approve significant non audit services that the auditor will perform for the audited company. All these governance measures resulted in a shift in the composition of the average board of directors of European listed companies towards majority independent boards in one tier board countries. As figure 1 illustrates the average European board is composed of 12% executive directors, 43% independent directors and 45% non-executive directors of different backgrounds (former executives, employee representatives, shareholder representatives and other kinds of directors). The super-majority non-executive (independent) board structure questions the legal requirement in one-tier countries of the board "governing" the company while it follows from the composition that it's primarily role is monitoring.

---

[1] The Motte case, Cass. Civ. June 4, 1946 *JCP*, 1947, II, 3518, note Bastian.
[2] The Forumbank Case, Hoge Raad January 21, 1955, *NJ* 1959, 43

Figure 1.



Source: adapted from Heidrick & Struggles, Challenging Board Performance, 2011, p. 42.

However, these adjustments did not end the governance debate and the drive to introduce new corporate governance features remains on stream. In the aftermath of the financial crisis, both the US Parliament and European and the national member states' legislators refined corporate law and allocated more (monitoring) powers in the hands of the (general meeting of) shareholders. In the Netherlands article 107a Boek 2 Civil Code requires the approval of the general meeting of shareholders to change the "identity and character" of the company, the American Dodd Frank Act empowers in section 971 the SEC to issue rules that a shareholder can include in the proxy statement a nominee to serve on the board of directors, a basic right for shareholders of European companies. The British Companies Act 2006 requires the general meeting to approve political donations of more than 5000 £.[3] The French Commercial Code provides the general meeting of shareholders with the right to approve all contracts entered into with a member of the (supervisory) board and shareholder with a voting block of more than 10 %.[4] Many European member states introduced the (advisory) right for shareholders to vote on the remuneration policy of the board of directors and top management of the company next to thresholds for different gender members and considerations for additional regulatory corporate governance moves like professional diversity of board members, external effectiveness assessments of boards, monitoring mechanisms of asset managers by institutional investors, etc. The general meeting of Belgian companies must approve golden parachutes for board members or top executives of more than 12 to 18 months.[5] The shareholders rights directive must not be missing in this list although the directive focuses on formal aspects of the general meeting of shareholders, like the

[3] Section 366 Companies Act 2006.
[4] Article L225-38 and L225-40 Commercial Code.
[5] Article 554 Companies Code; see for an analysis De Wulf, Van der Elst and Vermeesch (2010).

requirement to provide in the timely information. The division of powers between the board and the general meeting largely remains the competence of the member states. [6]

In the next sections we assess the importance of shareholder rights for shareholders in Western European countries. First we address the development of these rights over the last fifteen years and relate the development to the evolution of the shareholder structure of a large sample of listed entities. Next we study if and how major and small shareholders use their voting rights in general meetings and we assess the importance of the different voting items on the agenda of these meetings. Section four discusses the main finding and concludes.

THE LEXIMETRIC APPROACH OF SHAREHOLDER RIGHTS AND OWNERSHIP

DEVELOPMENT OF SHAREHOLDER RIGHTS

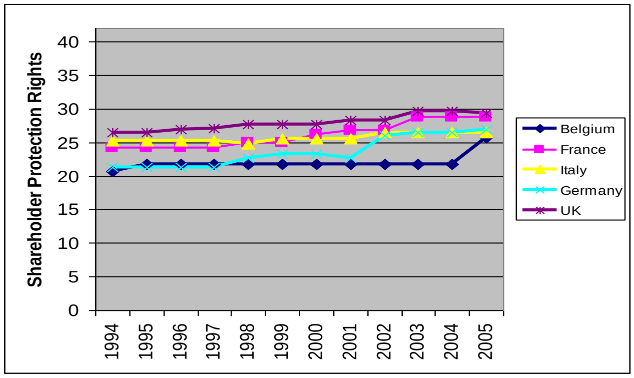
The leximetric law and finance literature studies the evolution of shareholder rights. The seminal work of La Porta, Lopez-de-Silanes, Shleifer and Vishny (1997, hereafter LLSV)) was the start of this type of law and finance research. In their study the authors analysed the influence of shareholder protection mechanisms on the financial development of countries. Later, the analysis of the development of shareholder rights became a derivative research topic. Lele and Siems (2007) developed an index that traces the shareholder protection levels in different countries. Not every right is covered, but in a diligent way they combine the rights in corporate law while taken into account considerations of contract law and civil procedure. The index is decomposed in individual rights, which are not necessarily binary. In some countries the identified shareholder right is not fully captured, but shareholders are partially protected. The composition of the board of directors serves as an example. While a majority of non-executive directors can be seen as an optimal shareholder protection, a minority of non-executive directors cannot be treated equally as a board that is solely composed of executive directors. The non-binary approach captures much better the legal framework in many countries, famous and criticized for the numerous “yes, but” or “no, unless” rules.

The variables in the index are not weighted in order to limit the arbitrariness. The agenda power setting is of equal importance as the prohibition of issuing multiple voting rights. The authors Lele and Siems argue that the large number of variables together with the functional equivalents in the different juridictions sufficiently captures the comparability of the national results.

---

[6] Exceptions are i.a. the approval of mergers (third company law directive) and divisions (sixth company law directive) and the acquisition of own shares (second company law directive).

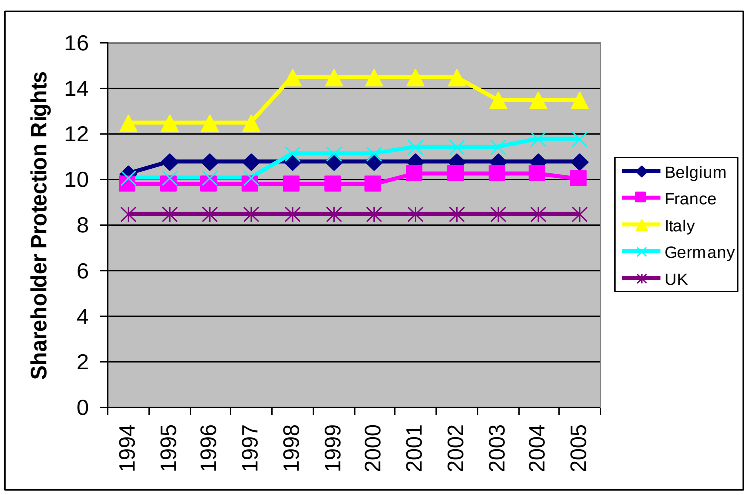
Figure 2: Development of "Anti-Director Rights"



Source: France, Germany and UK: P. Lele and M. Siems, "Shareholder Protection: A Leximetric Approach", Journal of Corporate Law Studies 2007, 17-50; Belgium and Italy: own research

The index presents the evolution of shareholder rights over a period of 35 years and developed it further in two separate indices, one relating to the protection against board and management ("Anti-Director Rights index) and one relating to the protection against other (large) shareholders (Anti-Blockholder Rights index). The board index contains 42 anti-director rights, the shareholder index is composed of 18 anti-blockholder rights. The evolution of these rights between 1994 and 2005 is presented in the figures 2 to 4. Next to the data of Lele and Siems the figures include the development of shareholder rights in Belgium and Italy (own research).

Figure 3: Development of "Anti-Blockholder Rights"



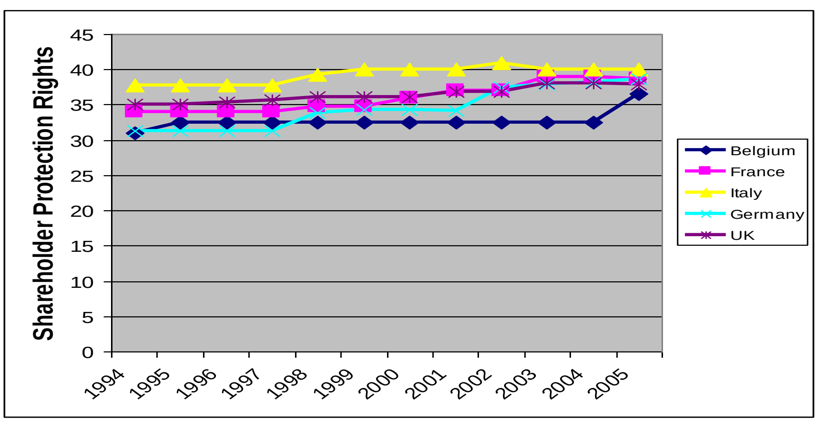
Source: France, Germany and UK: P. Lele and M. Siems, "Shareholder Protection: A Leximetric Approach", Journal of Corporate Law Studies 2007, 17-50; Belgium and Italy: own research

The "Anti-Director Rights" index shows an increase in shareholder rights in all countries (figure 2). By the end of 2005 all countries offered all shareholders between 25 and 30 rights (on a scale of 42 rights). The variability of the rights between the five developed countries is limited and even decreased over the years. Whilst Belgium offered less than half of the total number of rights to shareholders in 1994 and the UK already offered more than 26 rights (more than 60 per cent of the total number of rights), the differences between the countries, the differences between the best – the UK – and the worst performing country – Belgium – was less than 4 "rights" in 2005.

The development of the "Anti-Blockholder Rights" index shows a different pattern (figure 3). In three out of five countries, minority shareholders experienced hardly any increase in the number of shareholder rights. In France the latest development was even negative: the quorum rules for decision making processes at general meetings of shareholders were softened. A similar pattern can be found in Italy.

Figure 4 shows the development of the total number of shareholder rights in the five countries. The differences between countries are limited. All countries support shareholders with 35 to 40 shareholder rights out of 60 different rights. While France and Germany experienced a steady increase in the number of rights due to several legislative initiatives, Belgium had only two influential reforms: the amendment of the companies act in 1995 and the publication of a voluntary comply or explain code at the end of 2004.[7]

Figure 4: Development of Shareholder Protection Rights



Source: France, Germany and UK: P. Lele and M. Siems, "Shareholder Protection: A Leximetric Approach", Journal of Corporate Law Studies 2007, 17-50; Belgium and Italy: own research

[7] Another important development was the "corporate governance" law of 2002. However, the reform aimed at the independence of auditors, a modified two tier system, conflicts of interests in groups and several other formalities regarding the organisation of the general meeting. The law did not change any of the shareholder protection rights envisaged in the index. The voluntary corporate governance code became mandatory in 2010.

The divergent development of the “Anti-Director Rights” index and the “Anti-Blockholder rights” index is illustrated in table 1. Between 1997 and 2005[8] shareholders of Belgian, French and German companies experienced a statistically significant increase of protection against inappropriate behaviour of board and management. In Italy and the UK the increase was limited and not statistically significant. However, the index does not take into account the significant changes in the Companies Act 2006.

Whilst all countries developed more “Anti-Director rights”, protection of minority shareholders against expropriation behaviour of major blockholders remained moderate. None of the countries significantly increased the protection level, as the paired-sample T-test indicates. As continental European countries are confronted with many more blockholders, it could have been expected that these countries would have focused on this type of protective measures. The total shareholder protection index increased significantly in the three continental European countries where the anti-directors rights index improved.

[8] These data have been withheld to be comparable with the development of the ownership data.

Table 1: Paired T-test of shareholder rights in five countries in 1997 and 2005

Anti-director rights				
	1997	**2005**	**Corr. 97vs 05**	**t-value 97 vs 05**
Belgium	21,75	25,75	0,842	2,442**
France	24,25	28,75	0,839	3,232*
Germany	21,25	27	0,654	2,600**
Italy	25,25	26,5	0.836	0,741
UK***	27,625	29,375	0,903	1,638
Minority protection rights				
Belgium	10,25	10,75	1.000	-
France	9,75	10	0,952	0,437
Germany	10,08	11,75	0,524	0,894
Italy	12,5	13,5	0,561	0,566
UK***	8,5	8,5	1.000	-
All protection rights				
Belgium	31	32,5	0,881	2,399**
France	34	37	0,874	3,098*
Germany	31,33	37,09	0,607	2,586**
Italy	37,75	41	0,76	0,932
UK***	35,375	36,875	0,943	1,628

***: 99 vs 05; *: significant at 1%; **: significant at 5%

Source: C. Van der Elst, "The Influence of Shareholder Rights on Shareholder Behavior", Corporate Finance and Capital Markets Law Review, 2010/1, p. 58.

DEVELOPMENT OF OWNERSHIP STRUCTURES

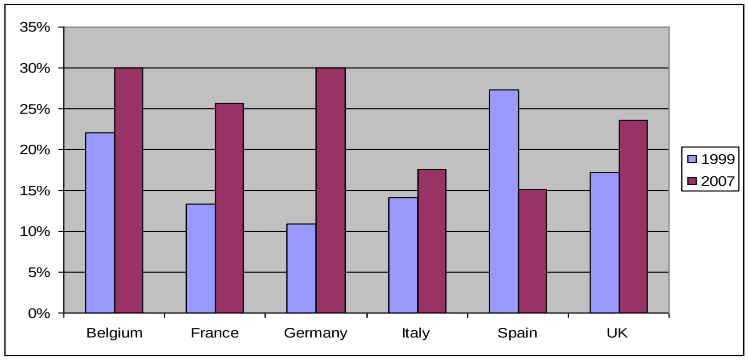
In a "law and finance" setting the increase in the number of shareholder rights against shirking of directors suggests that the ownership concentration levels will decrease. Enhanced protection of the position of the shareholder will no longer require the same level of highly concentrated ownership as the latter is substituted by (the provision of) more shareholder rights. The insignificant increase in the number of minority shareholders rights against expropriation by controlling shareholders, implies that minority shareholders remain confronted with a significant probability of controlling shareholder expropriation. The impact of this status quo on the developments of the size of voting blocks of minority shareholders is ambiguous. It can be argued that minority shareholders will increase their voting power in order to counterbalance the position of the controlling shareholder. However, it is also possible that the minority shareholders reduce the exposure of expropriation by reducing their position in controlled companies.

As “law and finance” is straightforward in predicting the impact of more shareholder rights in companies with a more dispersed ownership structure, the recent development of the ownership of different shareholders classes in companies with a more dispersed ownership is studied in this section. As these classes of shareholders, and in particular the foreign shareholders must rely on the qualities of the legal system it can be argued that they are more sensitive to formal legal developments.

We collected ownership data of more than 1800 listed companies in six European countries in 1999: Belgium, France, Germany, Italy, Spain and the UK. In 2007 approximately half of these companies were delisted for numerous different reasons. For the remaining group of 900 companies we identified all voting blockholders (more than 5%) in 1999 and 2007 and classified these shareholders in six different classes: individuals, non-financial companies, banks, insurance companies, other financials, government, foreign shareholder.

Companies experienced an internationalisation of their ownership structure. Whereas the home country bias did not (yet) completely disappear, the increasing number of foreign shareholders acquiring large blocks in many European companies illustrates the decreasing importance of “local” investment policies. This development is more than likely due to the significant efforts of the European Union to develop an integrated capital market. In Belgium and Germany 30 per cent of all large stakes are in hands of foreign shareholders (figure 5). In France and the UK one of every four stakes belongs to overseas shareholders. Southern European countries are lagging behind with 15 per cent to 20 per cent foreign blockholders. The internationalisation of the shareholder structure was remarkable in Germany and France. In Germany the growth in numbers over a period of eight years was almost 300 per cent and in France the number of foreign stakes doubled. Belgium and the UK which already had a relative high number of foreign shareholders in 1999, had rather modest growth rates. Southern European countries like Italy and Spain did not develop in a similar way. Italy experienced a small increase and in Spain the number of large foreign shareholders significantly decreased.

Figure 5: Relative number of large stakes (>5%) in hands of foreign shareholders



Source: C. Van der Elst, Are Shareholder Rights Appealing to Foreign Shareholders?, in Festschrift für Klaus Hopt, Berlin, W. De Gruyter, 2010, 634.

More in general it can be argued that since the turn of the millennium there is a significant shift in the ownership structure of European companies. The inflow of foreign shareholders in many countries suggests that foreigners have more confidence in the foreign (shareholder rights') system. We address this assumption through an analysis of the development of the voting blocks of the different classes of shareholders. The average voting block size is studied over time and in relation to the shareholder rights.

Table 2 provides information of the average voting block of different types of small blockholders in companies without a controlling shareholder holding more than 30 per cent or 1/3 of the voting rights for France. This is the mandatory takeover threshold. Overall, the results show that minority blockholders did not significantly change their shareholdings over the period of 1999 and 2007. Most individuals and families hold a voting block between 10 per cent and 15 per cent in non-controlled companies and did not significantly change their investment policies in the first decade of the new millennium. In non-controlled companies, non-financial companies behave similar in different countries: they acquired a voting block of 10 to 15 per cent. This policy did not change over the years. The influence of shareholder rights on the investment behavior of non-financial companies cannot be found in the data. Banks invested differently in French and German and Belgian companies. In the latter countries banks acquired larger minority blocks, in the former they marketed part of their blocks. However in no country the difference between 1999 and 2007 is significant. Finally, foreign shareholders of non-controlled companies increased their average minority voting block in Germany and the UK but diminished their stake in other countries. In none of the countries the change in minority blockholdership is significant.

Aforementioned we found that in Belgium, France and Germany the index of "anti-director rights" significantly increased between 1997 and 2005. In Italy and the UK the index did not significantly change. Table 2 illustrates that the different types of shareholders did not significantly change their investment policy in none of the aforementioned countries. Some shareholder classes like banks even increased their voting blocks in countries like Germany and Belgium where the shareholder rights significantly increased. It sheds doubt on the inverse linear relationship between shareholder rights and dispersion of ownership.

Table 2: Average voting block of different types of shareholders in non-controlled companies

families as small blockholders					non-financial shareh. as small blockholders		
	1999	2007	t-value		1999	2007	t-value
Belgium	12,1%	9,5%	-1,539		13,6%	13,3%	-0,213
France	15,2%	15,8%	0,245		13,7%	13,6%	-0,022
Germany	13,3%	12,5%	-0,797		14,1%	13,5%	-0,323
Italy	15,0%	12,1%	-1,142		15,0%	12,0%	-1,142
Spain	11,6%	11,6%	-0,035		10,7%	10,3%	-0,306
UK	11,8%	12,1%	0,462		13,7%	14,9%	0,645
Banks as small blockholders					foreign shareholders as small blockholders		
	1999	2007	t-value		1999	2007	t-value
Belgium	8,4%	10,1%	0,813		12,1%	9,5%	-1,539
France	7,7%	6,6%	-0,842		15,2%	15,8%	0,245
Germany	12,7%	13,8%	0,481		13,3%	12,5%	-0,797
Italy	9,6%	9,3%	-0,222		15,0%	12,1%	-1,142
Spain	8,6%	8,3%	-0,242		11,6%	11,6%	-0,035
UK	10,9%	8,6%	-0,547		11,8%	12,1%	0,462

Source: C. Van der Elst, "The Influence of Shareholder Rights on Shareholder Behavior", Corporate Finance and Capital Markets Law Review, 2010/1, 61.

It is more than likely that other features drive the development of ownership structures. These factors can be of a legal nature or non legal nature: in Europe, UCITS may not invest more than 5% of its assets in transferable securities or money market instruments issued by the same body and are prohibited to acquire any shares carrying voting rights which would enable it to exercise a significant influence over the management of an issuing body. Next, Many shareholder rights are related to a specific threshold: 5 per cent is required to call a general meeting, 25 per cent or 1/3 blocks important decisions, 30 per cent or 1/3 triggers the mandatory bid offer, 50 per cent controls the general meeting, 75 per cent changes the articles of association and 95 per cent squeezes the minority shareholders. Only a small number of these thresholds seem to be influential determinants for shareholder voting block acquisitions. A different feature is shareholder specific: some Belgian families control a listed company through a Dutch trust (“administratiekantoor”) allowing the separation of financial benefits and the controlling power. Another non-legal development which became visible in the first decade of the new millennium are the acquisitions of private equity funds and foreign hedge funds in particular in Germany and France. The average disclosed voting block must be considered as higher than can be expected from a pure financial investment perspective. In both countries the average voting block is almost 25 per cent. They can be considered as activists that buy stakes in undervalued companies (Cheffins and Armour, 2011).

SHAREHOLDERS’ VOICE POLICY AND SHAREHOLDER RIGHTS

Aforementioned it was illustrated that the shareholders – acting together in the general meeting of shareholders – were historically considered the supreme and final decision makers of the company. The shareholders were – and still are today – presented at the top of the diagram representing the company. Shareholders are seen as “owners” of the company. However shareholders own the shares, not the company. When shareholders become numerous and shareholders change the ownership of the shares constantly, the allocation of all powers in hands of shareholders and general meeting becomes unworkable. Today the residual powers shifted to the board of directors and the general meeting of shareholders can only vote on the issues that the law or the articles of association are willing to provide to the general meeting. As long as corporate issues cannot or are not subject to a vote, the right to vote is of limited value.

The shareholders’ meeting is not deprived of all powers. In recent times shareholder empowerment is key in the corporate governance discussion and as it was illustrated (the general meeting of) shareholders were provided with new powers in many countries. In most countries the (general meetings of) shareholders are in charge of the election of the board of directors, a number of other recurrent corporate items and the “fundamental decisions” of the corporation. In one textbook it sounds: “In any case, however, it is the general meeting that decides on fundamental matters, such as the alteration of the articles, including the objects of the company, the transformation of the company into another legal person and its winding up”(Dorresteijn, A., T. Monteiro, C. Teichmann and E. Werlauff, 2009).

A large part of this important corporate decision making process takes place at (extra-ordinary and ordinary) general meetings of shareholders. It offers shareholders an important low cost activist strategy to influence the corporate decision making process. The general meeting is the decision making body for the shareholders and shareholders can react to deteriorating performance by using voting rights to elect new directors or change the structure of the company. It serves as the arena for the confrontation between shareholders and the board of directors.

However, shareholders are confronted with a collective action problem. Every shareholder has to study, analyse and decide on the efforts of the board or changes of the corporation. The cost might exceed the expected benefits and shareholders will be rational apathetic and free ride on the efforts of the other shareholders. Initiatives to empower and engage shareholders have to take into account these problems in order to avoid costly red tape regulation.

Attending the general meeting and voting provides a setting to assess the impact of shareholder enhancing policies and the effect of shareholder empowerment. More in particular, companies that are in a process of restructuring or reorganization, want to buy back shares, change the article of association etc. will have more items on the agenda of the general meeting than companies that are performing in line with (previously determined) strategy or disclose better than expected results. The probability of free riding behavior and rational apathy will decrease when the agenda of the general meeting provides more items for which shareholders have to vote. Both large voting blockholders as well as small shareholders have more incentives to actively participate if the agenda of the general meeting of shareholders is longer and contains more important agenda items. Accordingly a positive relationship between the overall voting turnout of shareholders at general meetings and the importance of the meeting can be predicted. The effect on the voting support of the individual proposals is less clear. It depends on many different factors and in particular the expectation of shareholders that the agenda item is shareholder value enhancing or not. In this section we investigate the impact of shareholder rights on shareholder participation of the 2010 general meetings of large companies in five countries and we address the relationship between the importance of the general meeting and the voting turnout of shareholders. We selected the Bel-20 companies for Belgium, the DAX-30 companies for Germany, the CAC-40 companies for France, the AEX(-25) companies for the Netherlands and the Footsie-100 companies for the UK. 17 Belgian, 26 German, 37 French, and 19 Dutch companies provided the necessary information. As the UK companies would outnumber the number of companies of all other countries, the sample of UK companies was further reduced to 51 randomly selected companies.

The voting turnout of shareholders is measured in two distinctive ways for different kinds of shareholders. The overall voting turnout takes into account all shareholders that participate in the annual general meeting (AGM). A minority of the shareholders attend the AGM in person, a majority vote by proxy, while in some cases other means to participate are available, like voting by mail. The voting turnout of small shareholders starts from the premise that large shareholders effectively vote, although there is no mandatory requirement to do so. This premise finds support in the analysis of the data from which it is clear that the absenteeism of these shareholders would result in much lower voting turnouts.

The attendance of shareholders is measured as (i) the total relative voting turnout or (ii) the relative voting turnout of small shareholders calculated as: (total relative voting turnout – summed voting block of all blockholders)/(100 per cent – summed voting block of all blockholders)

To measure the importance of the AGM three different variables are used. The first variable is AGM items. It is calculated as the total number of items for which the shareholders can vote less the items which are pure formalities and counting the items, which have been subdivided in several subitems as one item. The latter technique is applied to increase the comparability of the data. As an example I refer to the AGM of French companies where the last item of the agenda is almost always the authorization to the board or the chairman of the board to perform all the formalities related to the other items that the general meeting has approved. This item is excluded from the total number of items as the item does not increase the "importance" of the meeting. As an example of "subitems" I again refer to the French AGM that not only has to approve the accounts of the accounting period but also has to approve the consolidated accounts. As the AGM in the other countries only approve the accounts (and discloses the consolidated accounts), the separate approval of both the annual account and the consolidated accounts in France is counted as one item. Further I noted that in Belgium the AGM and the EGM are strictly separated from one another, while these meetings are de facto combined in France while the items of a Belgium EGM are considered as special resolutions in a UK AGM. For comparability reasons I added the items of the Belgium EGM that takes place immediately before or after the AGM, to the number of items of the AGM. Finally, I included the number of shareholder proposals in the variable. Only eight AGMs (5 per cent) had to vote on items proposed by shareholders.

The second measure of AGM importance is the number of "extra ordinary" items for which the shareholders have to vote. Corporate law considers some decisions, like the amendments of the articles of association, which are outside the regular company affairs, too important to be approved as 'ordinary' resolutions. These extra-ordinary or special resolutions require in Belgium and France a separate general meeting for which a specific quorum and majorities are applicable. In the UK and Germany these decisions must be considered as 'special' resolutions for which a 75 per cent majority is required. The Netherlands is more flexible. Only some decisions require a supermajority approval at Dutch AGMs if less than half of the capital is represented. With a variable "AGMextraitems" the influence of the number of extra-ordinary resolutions presented to the shareholders is measured. It is expected that these resolutions will increase the willingness of shareholders to participate.

A third variable of AGM importance is the number of board members the AGM have to elect. The number of AGM items is measured considering all director elections as one item. From the agency theory it can be derived that the election of the best directors is one of the most important tasks of an AGM. Therefore I also added the variable “AGM dir. Elected”. This variable is calculated as the number of (supervisory) board members that AGM’s elect.

As many other variables can influence attendance and voting at the meeting of shareholders, the analysis is expanded with ownership variables, financial performance variables, governance variables and company specific variables like the size of the company.

Ownership structure comprises both the ownership concentration and the types of blockholders. As ownership concentration measures, I both use the voting block of the largest shareholders and the summed voting blocks of all large shareholders with more than 5 per cent of the votes. The financial performance variable is measured by the total shareholder return. It is calculated as the relative change of the stock price at the start of the accounting period and the stock price at the end of the accounting period including the dividend. Board governance comprises both the number of meetings of the board and the relative number of independent directors. It can be expected that more independent and more active boards will negatively affect the voting turnouts as these corporate governance instruments serve as alternatives for shareholder monitoring. German supervisory boards are subdivided in employee representatives and shareholder representatives. Independence is not considered as an important corporate governance feature in Germany. Regressions that make use of this variable could not take into account the German companies. Finally a number of control variables have been used. Size of the company is measured as the logarithm of the market capitalization in millions of euro[9] at the end of the accounting period.

Table 3 shows that the average and median voting turnout at AGMs is 60 per cent. The relative voting turnout of small shareholders is lower than the overall voting turnout. The average voting turnout of this type of shareholders is 45 per cent with a median value of 49 per cent. The difference between the overall voting turnout and the voting turnout of the small shareholders is significant at the 1 per cent level (paired t: 12,14). It might be due to the fact that small shareholders are more eager to free ride although cost considerations can also explain the decision of small shareholders not to make use of the voting rights.

[9] For UK companies the market capitalization in pound was transposed in euro at the conversion rate of the final day of the accounting period.

Table 3: Descriptive statistics of the voting turnout at AGMs

	n	mean	std	min	q1	med	q3	max
total relative voting turnout	153	59,52%	13,25%	17,66%	53,06%	60,21%	69,98%	92,03%
small shareh. voting turnout	150	45,13%	16,91%	1,24%	36,95%	48,72%	57,08%	74,46%

Source: C. Van der Elst, Revisiting shareholder activism at the AGMs: Voting determinants of large and small shareholders, ECGI Finance working paper nr. 311, July 2011, table 1.

Table 4 summarizes the descriptive statistics of the explanatory variables. Shareholders have to vote on 12 different items on average, with a maximum of 37 in one Belgium company, and a minimum of 5 items (6 companies). The median number of agenda items is 11. The differences between countries are small. The average number of 'special' resolutions is 4,5 and more than half of the companies list three to five 'special' resolutions in the agenda. Each AGM has to (re)elect 4 directors on average, going up to as much as 20 directors that stand for (re)election in one French board, five of which were proposed by the employees but rejected by a large majority of the shareholders. The (re)election of 20 board members can be considered as an outlier as the next highest number of (re)election of directors is 14.

The largest average voting block of these national "blue chips" companies is 18 per cent. This average is heavily influenced by a small number of controlled companies. The median voting block of the largest shareholder is only 11 per cent. The summed voting block of all large shareholders exceeds 25 per cent but 50 per cent of the companies have only 20 per cent of their votes in hands of large shareholders. The accounting period of 2009 was from a stock performance perspective shareholder friendly. The average total shareholder return was 37 per cent, the median was 20 per cent. Boards of directors meet on average each 1,5 months. Boards of directors are composed of a large majority of independent directors. On average, approximately two thirds of the board is independent. On average 26 equity analysts cover a company in our sample and half of the companies are covered by at least 27 analysts. The companies in the sample are large. The median market value of the companies is 7,9 bio. €, and the average is even more than 18,5 bio. €.

Table 4: Descriptive statistics of the AGM items, ownership structure, performance, governance and size of companies

	n	mean	std	min	q1	med	q3	max
AGM items	153	11,76	4,51	5	9	11	13	37
AGM extra items	152	4,53	3,28	0	3	4	5	18
AGM dir elected	153	4,33	3,53	0	2	4	6	20
voting block largest	153	18,05%	16,69%	<5%	6,84%	10,80%	27,14%	84,48%
sum voting blocks	153	25,07%	20,24%	<5%	7,53%	19,98%	37,67%	90,12%
total shareholder return	153	37,03%	52,04%	-60,91%	7,98%	19,82%	56,63%	446,17%
board meetings	151	8,63	3,93	4	6	8	10	33
independence	122	64,38%	20,47%	13,64%	53,62%	65,48%	77,78%	100%
Analyst coverage	153	26,34	7,83	7	21	27	32	43
market cap in mio €	153	18533	24768	870	4294	7902	22799	138905
log (market cap)	153	3,99	0,48	2,94	3,63	3,9	4,36	5,14

Source: C. Van der Elst, Revisiting shareholder activism at the AGMs: Voting determinants of large and small shareholders, ECGI Finance working paper nr. 311, July 2011, table 2.

Table 5 presents Pearson's correlation coefficients between the explanatory variables. I generally find low pairwise correlation coefficients among the variables, but some of our test variables are highly correlated causing concern that multicollinearity could affect the regression results if not mitigated. The number of AGM items includes the extra items and both variables are correlated. As both are used to test the importance of the meeting on voting turnout they will not be entered in the same regression. The second regression will also mitigate the significant correlation between the number of board meetings and the number of AGM items. The number of directors to be elected is positively correlated with the size of the company. Larger companies generally have more directors and hence the number of directors that need to be (re)elected is generally higher for this type of companies. The largest voting block and the summed voting blocks of all large shareholders are also significantly correlated. These variables will be entered in separate regressions. Ownership measures are also significantly negative related with board independence. The more concentrated the ownership the lower the relative number of independent directors. The number of analysts is positively associated with the size of the company. It does not come as a surprise as it is logic that larger companies receive more attention of the financial markets.

Table 5: Correlation coefficients between the explanatory variables AGM importance, ownership, performance and governance

	AGM items	AGM extra items	AGM dir. Elected	voting block largest	sum voting blocks	total shareholder return	Indepen-dence	board meetings	analysts
AGM extra items	**0,729**								
AGM dir. elected	0,201	0,137							
voting block largest	0,026	-0,020	-0,140						
sum voting blocks	0,007	-0,010	-0,096	**0,877**					
total shareholder return	-0,121	-0,075	0,009	0,017	0,054				
independence	-0,139	-0,126	-0,135	**-0,494**	**-0,510**	0,178			
board meetings	**0,357**	0,143	0,193	-0,136	-0,095	-0,082	0,033		
analysts	0,098	0,121	-0,083	-0,114	-0,192	-0,148	0,137	-0,080	
log (market cap)	0,177	0,141	**0,234**	-0,060	-0,145	-0,097	-0,074	0,100	**0,615**

This table reports Pearson's correlation coefficients for all variables used in the regressions. Spearman correlations (unreported for brevity) are consistent with the Pearson correlations. Boldface indicates statistical significance at the 1% level. Source: C. Van der Elst, Revisiting shareholder activism at the AGMs: Voting determinants of large and small shareholders, ECGI Finance working paper nr. 311, July 2011, table 3.

OLS analysis is used to estimate the effects of the importance of the general meeting, ownership structure, financial performance and board monitoring on voting turnout of all shareholders and small shareholders separately.

The results of the regressions with the voting turnout of all shareholders as the dependent variable can be found in the first three columns of table 6. First, the number of agenda items for which the shareholder can vote is assessed. The results show that there are no significant relationships with the total voting turnout. Similarly the decision of the board of directors to combine the meeting with specific and important items for which most of the time supermajority approval quora are legally prescribed, does not influence the attendance behaviour of shareholders. The number of directors to be elected at the general meeting positively influences the voting turnout. With each director to be (re)elected, the attendance of shareholders increases with almost one per cent. Ownership concentration drives voting turnout. Blockholders positively affect the total voting turnout. When the concentration of shares in the hands of the shareholders with more than 5 per cent of the voting rights increase with 1 per cent, the total voting turnout at the meeting increases with 0,25 to 0,34 per cent. It does not make a difference whether the concentration is due to the larger position of the largest shareholder or the increase in voting rights of the other blockholders, although the effect differs. Blockholders, other than the largest shareholder, are more eager to participate than the largest shareholder. The regression coefficient of the sum of voting blocks is larger than the coefficient of the voting block of the largest shareholder. The type of the blockholders plays an important role for the voting turnout. The financial performance of the company positively affects the voting turnout, although the influence is limited. An increase of the total shareholder return of 10 per cent results in an increase of the voting turnout of 0,5 per cent. Other techniques of monitoring do not substitute for shareholder voting at AGM. More board meetings, more independent boards and more analysts have hardly any significant negative effect on voting turnout. Finally, general meetings of larger companies experience more shareholder attendance.

Table 6: Relation between importance of general meetings, ownership, financial performance, board and analyst monitoring and shareholder's voting turnout

The dependent variable in the first three columns of the OLS regressions is the total voting turnout in percent. The dependent variable in the last two columns of the OLS regressions is the voting turnout in percent of small shareholders. The voting turnout is calculated as (total relative voting turnout – summed voting block of all blockholders)/(100 per cent – summed voting block of all blockholders). The independent variables are AGM items which is the total number of regular AGM items for which shareholders have to issue a vote, AGM extra items which is the number of special resolutions or the number of items of the extraordinary general meeting that precedes or follows the AGM, AGM dir. Elections is the total number of directors that stand up for (re)elections, voting block largest is the voting block of the largest shareholder in percent, sum voting block is the summed voting block of all shareholders with a voting block of more than 5 percent, total shareholder return is the percent difference of the stock price at the end of the accounting period (including the dividend) and at the start of the accounting period, board independence is the percent of independent board members, board meetings is the number of board meetings during the accounting period, analysts is the number of analysts that according to Reuters follow the company, log (market cap) is the logarithm of the market capitalization in mio. euro at the end of the accounting period. T-values are between brackets. *, **, and *** denote statistical significance at the 10%, 5%, and 1% levels, respectively.

	voting turnout all shareholders				voting turnout small shareholders	
constant	33,49	43,166	43,801		21,957	43,209
	(3,289)***	(9,021)***	(4,273)***		(1,842)*	(6,543)***
AGM items	-0,05		0,06		-0,097	
	(-0,023)		(0,244)		(-0,316)	
AGM extra items		0,265				0,144
		(0,922)				(0,365)
AGM dir. Elections		0,834				0,906
		(3,071)***				(2,437)**
voting block largest			0,170			
			(2,178)**			
sum voting blocks	0,253	0,338			-0,404	-0,310
	(4,070)***	(7,162)***			(-4,789)***	(-4,546)***
total shareholder return	0,047	0,042	0,052		0,065	0,065
	(2,497)**	(2,348)**	(2,660)***		(2,537)**	(2,644)**
independence	-0,083		-0,139		0,607	
	(-1,364)		(-2,222)**		(0,683)	
board meetings		-0,250	-0,324			-0,245
		(-1,032)	(-1,119)			(-0,737)
analysts		0,135				0,167
		(1,106)				(0,981)
log (market cap)	6,219		5,724		6,958	
	(2,952)***		(2,596)**		(2,010)**	
adj R	0,258	0,297	0,196		0,265	0,177
F	9,42	11,326	5,873		9,648	6,178
N	122	148	121		121	145

Source: C. Van der Elst, Revisiting shareholder activism at the AGMs: Voting determinants of large and small shareholders, ECGI Finance working paper nr. 311, July 2011, table 4 and 5.

The last two columns of figure 6 present the OLS results of the relationship between the importance of the meeting, ownership structure, financial performance, board and external monitoring and the voting turnout of small shareholders. Many of the results are similar with those that have been found for the overall shareholder voting turnout. First, only the number of directors to be elected influences the attendance of small shareholders, other items on the agenda of the AGM do not activate the small shareholder's willingness to participate. Second, the financial performance of the company positively affects the voting turnout of small shareholders. Third, the independence of the board, the number of board meetings and the number of analysts that observe the company have no effect on the attendance of small shareholders. Fourth, larger companies receive relatively more small shareholders at their AGM than smaller companies. The most important difference with the voting turnout of all shareholders is the influence of the ownership structure of the company. The concentration of voting rights in hands of blockholders negatively affects the voting turnout of small shareholders. Every increase of the voting rights in the hands of blockholders with one percent reduces the attendance of small shareholders with 0,30 to 0,40 per cent.

In sum, the voting turnout of shareholder is not always higher if the shareholders can vote on more items. Only when more directors are (re)elected the voting turnout is positively influenced. Shareholders engagement via general meetings is not a linear function of shareholder rights.

POLICY CONCLUSION

Shareholder engagement is high on the agenda of policymakers. In the Green Paper on Corporate Governance of April 2011 of the European Commission it sounds: "Shareholder engagement is generally understood as actively monitoring companies, engaging in a dialogue with the company's board, and using shareholder rights, *including voting* and cooperation with other shareholders, if need be to improve the governance of the investee company in the interests of long-term value creation."

The position of the European Commission implies that (i) shareholder rights must be provided so as guarantee that shareholders are in the position to engage in monitoring and (ii) voting is considered as an important corporate governance feature and high voting turnouts – more than high levels of opposition – illustrate shareholder engagement. Shareholders that vote show commitment to the company.

Shareholder engagement is only a means to improve corporate governance. The relationships at the level of the ownership of companies are manifold and difficult to harmonize in the corporate governance recommendations. Interference endangers the delicate balance between the rights of shareholders to act in their own interest and equal treatment of shareholders. Increasing shareholder power can only be successful if it properly addresses shareholders' interests to take part in this part of the governance debate. Not the number of items nor the right to vote on special resolutions changing the articles of association of the company, have significant impact on voting turnouts, although the opposition against the changes can be higher than the opposition for other items. There is also some evidence that over a longer period of time different legal reforms only temporary influenced voting turnouts (Mendoza, Van der Elst and Vermeulen, 2011). Many general meetings empower the board of directors to issue new shares, allow the annulment of shares, to reduce the capital and authorize the board to make use of poison pills in case of a hostile takeover bid. These items experience relatively higher opposition than other agenda items, but this study shows that these items do not influence the voting turnout itself. It provides evidence that the power of directors to take the decision which items must be put on the agenda of the company is efficient. This approach is applied in the U.S. where shareholders are less involved in corporate decision taking processes (Thomson and Edelman, 2009).

Director elections positively influence the voting turnout of both large and small shareholders. Shareholder engagement policies can concentrate on a limited number of highly influential issues like board member elections. For every director that has to be elected the voting turnout increases with almost 1 percent. Also smaller shareholders are more willing to attend meetings where more directors stand up for (re)election. Only in controlled companies director (re)elections can have a negative effect. One of the options could be to issue a recommendation to have the independent directors elected by the minority shareholders attending the meeting – independent from the ownership structure of the company – to provide more voice to small shareholders in controlled entities and at the same time enforce the position of these directors acting in the interests of all stakeholders.

It is important that European Commission provides in an efficient corporate governance framework. This framework should take into account the different pillars of corporate governance: corporate law, best practices as well as contractual arrangements. New mandatory requirements that are not supported by evidence that they will enhance the goal of the regulations must be avoided. As there is no clear evidence that mandatory shareholder engagement rules will enhance stewardship, it must be left to the contractual arrangements or best practices. We support an appropriate and comprehensive disclosure regime, disentangled from the rigid one size fits all best practice comply or explain technique, providing companies, boards, shareholders and markets the freedom to develop tailored made corporate governance configurations which validity will be appreciated by all stakeholders (Van der Elst and Vermeulen, 2011).

References

1. De Wulf, H. C. Van der Elst, S. Vermeesch, 2010. Radicalisering van corporate governance-regelgeving: remuneratie en transparantie na de wet van 6 april 2010, *Tijdschrift voor Belgisch Handelsrecht* 2010/10, pp. 909-963.
2. Dorresteijn, A. T. Monteiro, C. Teichmann and E. Werlauff, *European Corporate Law*, Kluwer Law International, Alphen aan de Rijn, 2009.
3. Cheffins, B. and J. Armour, 2011, *The Past, Present and Future of Shareholder Activism by Hedge Funds*, Legal Studies Research Paper Series Cambridge University nr. 38/2011, 93 pp.
4. Heidrick & Struggles, 2011. *Challenging Board Performance*, 42 pp.
5. La Porta, R., F. Lopez-de-Silanes, A. Shleifer and R. Vishny, 1997. Legal Determinants of External Finance, *Journal of Finance* 52, pp. 1131–1150.
6. Lele, P. and M. Siems, 2007. Shareholder Protection: A Leximetric Approach, *Journal of Corporate Law Studies*, pp. 17-50
7. Mendoza, J., C. Van der Elst and E. Vermeulen,2011. Entrepeneurship and Innovation: The Hidden Costs of Corporate Governance in Europe, *South Carolina Journal of International Law and Business* 7, Fall, pp. 1-47
8. Thompson, R. and P. Edelman, 2009. Corporate Voting, *Vanderbilt Law Review* 62, pp.129-175.
9. Van der Elst, C. 2010. The Influence of Shareholder Rights on Shareholder Behavior, *Corporate Finance and Capital Markets Law Review*, 2010/1, pp. 50-62.
10. Van der Elst, C. 2010. Are Shareholder Rights Appealing to Foreign Shareholders?, in *Festschrift für Klaus Hopt*, Berlin, W. De Gruyter, 2010, pp. 629-644.
11. Van der Elst, C. and E. Vermeulen,2011. Corporate Governance 2.0: Assessing the Green Paper of the European Commission, *European Company Law* 8, pp. 165-174.
12. Van der Elst, Christoph, *Revisiting Shareholder Activism at AGMs: Voting Determinants of Large and Small Shareholders* (July 16, 2011). ECGI - Finance Working Paper No. 311/2011; Tilburg Law School Research Paper No. 019/2011. Available at SSRN: http://ssrn.com/abstract=1886865.

Preliminary Communication
UDC 005.7(73)

Jonathan S. Abernethy

U.S. CORPORATE GOVERNANCE AND COMPLIANCE IN AN INCREASINGLY CHALLENGING REGULATORY ENVIRONMENT

Abstract

Increased regulation and well-publicized corporate scandals in the U.S. have caused boards of directors and management to focus more and more on legal and regulatory oversight. Companies today face two particular regulatory challenges. First, there is the U.S. Foreign Corrupt Practices Act (FCPA), which, broadly speaking, prohibits bribery of non-U.S. government officials and has a wide jurisdictional reach. Second, whistleblower provisions of the recently enacted Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") enable company employees and former employees to recover potentially huge bounties for reporting corporate misconduct. This paper examines these two regulatory challenges and ways in which companies can institute and augment compliance programs to mitigate the risks they pose.

INTRODUCTION

The U.S. has well-developed developed corporate governance standards based on concepts such as financial transparency, disclosure of material events, sound risk management, proper internal controls, and independence of a majority of the corporation's board of directors. Corporate governance standards in the U.S. have existed for approximately 150 years, when the New York Stock Exchange first adopted rules for the issuance of regular financial statements, quarterly earnings announcements, and independent audits of a company's financials.[1]

At their core, corporate governance standards for U.S. public companies are designed to protect shareholders. The overarching objective of boards of directors is to maximize long-term shareholder value. However, due to well-publicized scandals such as Enron and WorldCom, and increasing regulation over the past decade, boards must now focus far more on legal and regulatory oversight that they did previously.[2]

This paper examines two challenges in particular that U.S. companies face in this increased regulatory environment: the challenges facing multinational companies in ensuring compliance with the FCPA and the challenges to companies posed by the whistleblower provisions of the Dodd-Frank Act. In light of these challenges, and because of regulators' ever-increasing focus on corporate wrongdoing, boards of directors and corporate management will likely need to spend even more time on legal and regulatory oversight, and, in particular, overseeing compliance programs, in the future.

OVERVIEW OF THE FOREIGN CORRUPT PRACTICES ACT

The Foreign Corrupt Practices Act, or FCPA, is a statute that prohibits bribery of "foreign officials" (non-U.S. government officials) for a commercial advantage.[3] More specifically, the FCPA prohibits corrupt payments or offers to pay money or anything of value to such officials or to third parties acting on their behalf, when such payments or offers to pay are made to assist in obtaining new business or retaining existing business. The term "foreign official" has been interpreted very broadly and may include, among other people, employees of state-owned or controlled entities; advisors or other persons acting on behalf of a government; party officials or candidates for political office; customs officials; and relatives of government officials. Those potentially subject to civil and criminal sanctions under the FCPA include companies whose securities are traded on U.S. stock exchanges and their subsidiaries; U.S. citizens, nationals, and residents; and, under some circumstances, foreign corporations and citizens of other countries.

---

[1] *Report of the New York Stock Exchange Commission on Corporate Governance* (September 23, 2010), at p. 1, available at http://www.nyse.com/pdfs/CCGReport.pdf.

[2] *Id.*at p. 16-17.

[3] 15 U.S.C. § 78dd-1 et seq.

In addition to the anti-bribery provisions of the FCPA, the FCPA contains accounting and internal controls provisions that, in essence, require U.S. public companies and foreign companies listed on U.S. stock exchanges to maintain accurate books and records and to have sound internal controls.[4]

The FCPA imposes harsh penalties on companies. Criminal violations of the anti-bribery provisions can lead to up to $2 million in fines for each violation. For violations of the accounting provisions, the fines can be up to $25 million per violation. In addition, the SEC may seek disgorgement of profits generated through corrupt payments. Companies may also be subject to debarment from government contracts for violating the anti-bribery provisions of the FCPA.

RECENT ENFORCEMENT OF THE FCPA

The last few years have seen a significant rise in enforcement of the FCPA by U.S. prosecutors and regulators. The U.S. Department of Justice ("DOJ") enforces the FCPA's criminal law provisions, while the U.S. Securities and Exchange Commission ("SEC") is responsible for non-criminal enforcement. Since December 2008, there have been eight settlements by corporations each with more than $100 million in combined civil and criminal fines, and five of those eight settlements had fines in excess of $300 million.[5]

Many if not most of the recent FCPA enforcement actions brought by the DOJ and SEC have involved so-called "third-party payments." As noted above, corrupt payment need not be made directly to a foreign official to violate the FCPA. Companies are equally liable if they utilize an intermediary such as a middleman or an agent to make such a payment. Among the most common scenarios is the use of third-party intermediaries such as business consultants or vendors to make payments to foreign officials. In these cases, payments made by the company to the business consultant are often accompanied by invoices with a vague or entirely absent description of services. In other instances, sales agents or vendors are used to pass on payments to foreign officials. In any situation involving the use of third-party intermediaries, a company can be liable under the FCPA if it knew a payment was being passed along to a foreign government official or if was aware of a "high probability" that the payment was being made and "consciously avoided" confirming this fact.

---

[4] 15 U.S.C. § 78m.
[5] The FCPA Blog, "Top 10 FCPA Enforcement Actions," last published April 8, 2011, available at http://www.fcpablog.com/blog/2011/4/8/jj-joins-new-top-ten.html.

Another significant recent trend of FCPA enforcement is the DOJ and SEC's targeting of non-U.S. companies. Of the ten largest FCPA fines imposed upon companies to date, eight have been against non-U.S. companies.[6] A non-U.S. company is subject to the jurisdiction of the FCPA if it lists its shares on U.S. exchanges. But the FCPA also subjects non-U.S. companies to liability for any acts committed in furtherance of a violation "while in the territory of the United States."[7] Although this provision on its face appears only to cover a non-U.S. company's acts while *physically located* in the U.S., the DOJ takes the view that there is jurisdiction whenever a non-U.S. company merely *causes* an act to be done within the territory of the U.S. by any person acting as that company's agent. Thus, for example, under the DOJ's expansive view, payments in furtherance of a bribery scheme made from one non-U.S. bank to another non-U.S. bank that merely pass through a correspondent U.S. bank could be sufficient to confer jurisdiction under the FCPA. The DOJ's expansive view has not yet been successfully challenged in court.

The FCPA's reach may also be extended to non-U.S. companies and employees by theories of liability such as conspiracy and aiding and abetting. Employees may face criminal liability even if they did not directly participate in bribery, were not the leaders of a bribery scheme, and did not know whether or how specific bribes were being paid. Conspiracy and aiding and abetting charges can be used to impose liability on actors who have no connection to the U.S. as long as they assist other actors in a scheme and those other actors have a U.S. connection.

FCPA AND ANTI-CORRUPTION COMPLIANCE

The increasing aggressiveness of U.S. authorities in enforcing the FCPA has led numerous companies to establish anti-corruption compliance programs or to augment existing compliance procedures. Among the many steps companies have taken is to establish due diligence procedures to ensure that their agents, middlemen and business partners are acting in compliance with the law and that the transactions companies engage in do not have corruption risks.

In conducting due diligence, companies with operations overseas must be attuned to FCPA "red flags," or examples of conduct that could suggest corrupt payments are being made. Red flags include unusual or excessive commission or payment requests by third-party intermediaries, retention of third-party intermediaries or joint venture partners who were recommended by government officials, an apparent lack of qualifications on the part of a the third party, a refusal by the third party to certify that it will not take any action that might cause a violation of the

---

[6] *Id.*

[7] 15 U.S.C. § 78dd-3(a).

FCPA, and a lack of transparency in expenses and accounting records on the part of the third party.[8] Companies must also be attuned to increased risks in areas of the world that have a history of corruption. The most widely-regarded indicator of such corruption "hot spots" is the annual Corruptions Perception Index by Transparency International, which ranks countries based on their perceived levels of corruption.[9]

In addition to due diligence, many companies have taken extensive steps to train their employees on the FCPA and particular corruption risks in their industry sector. FCPA compliance policies also routinely contain detailed procedures for authorizing, approving, and reimbursing gift, travel, meal, and entertainment expenses involving foreign officials. Such gifts, travel, meals and entertainment are "things of value" under the statute that, if given corruptly, can cause a company to be in violation of the FCPA. In addition, FCPA compliance programs often require employees to certify on an annual basis that they are unaware of any bribery or accounting and internal controls violations, or, if they are aware of such violations, to describe the conduct in question. These procedures allow companies to investigate potential violations and remediate them where necessary.

Compliance policies and procedures are a critical for multinationals, given the increasing aggressiveness of U.S. authorities in investigating and enforcing the FCPA and the penalties that can result from a violation. At their most basic level, training and robust compliance programs should decrease the likelihood that employees will engage in conduct that may violate the FCPA. In addition, compliance programs place companies in a better position to avoid prosecution or enforcement actions in the U.S. if their employees ever commit a violation of the FCPA. One of the most important factors that U.S. federal prosecutors consider in the decision whether to prosecute a corporation is "the existence and effectiveness of the corporation's pre-existing compliance program."[10] In addition, senior DOJ officials have emphasized that a company's compliance program is "one of the most important factors" that they consider in deciding whether to bring charges.[11]

Companies with effective compliance programs also are eligible for a significant reduction in criminal fines if they ever do face prosecution under the FCPA. Under the U.S. Sentencing Guidelines, the existence of such a program is a one of two factors that mitigate punishment.[12]

---

[8] *See* DOJ's Lay Person's Guide to the FCPA at p. 4, found at http://www.justice.gov/criminal/fraud/fcpa/docs/lay-persons-guide.pdf

[9] The Corruption Perceptions Index is available at http://www.transparency.org/policy_research/surveys_indices/cpi/2010/results.

[10] Principles of Federal Prosecution of Business Entities, United States Attorneys' Manual § 9-28.300.

[11] May 25, 2010 Speech by Acting Deputy Attorney General Gary Grindler to Compliance Week 2010.

[12] U.S.S.G. Ch. 8, Introductory Commentary. The other mitigating factor is whether the company self-reports any violation, cooperates in an investigation, and accepts responsibility for its criminal conduct.

The Sentencing Guidelines provide for a reduction in a fine "[if] the offense occurred even though the organization had in place at the time of the offense an effective compliance and ethics program."[13] In the civil enforcement context, among other factors, the SEC will examine whether a company had effective compliance procedures and will give credit in appropriate circumstances for such procedures.[14]

The incentives to institute robust compliance policies are therefore quite significant under the FCPA. But those incentives are even greater for multinationals who conduct business in the United Kingdom, due to the passage of the United Kingdom's Bribery Act, which took effect on July 1, 2011. The most draconian provision of the Bribery Act makes it a crime for companies who do business in the UK to fail to prevent bribery by their employees, agents, and subsidiaries. This is a strict liability provision, meaning that even if a company does not know that one or more of its employees, agents, or subsidiaries are engaging in bribery, it still faces liability. The Bribery Act does contain a defence, however: companies that can prove they had "adequate procedures" in place to prevent bribery will not be liable. Thus, for companies that do business in the U.K., having an effective compliance program in place is the only way to mount a defence to a charge of failing to prevent bribery by their employees, agents, and subsidiaries.

THE DODD-FRANK ACT'S WHISTLEBLOWER PROVISIONS

Another significant challenge for U.S. companies is the whistleblower provisions of the Dodd-Frank Act. These provisions require the SEC to award at least 10 percent and no more than 30 percent of total monetary sanctions to a whistleblower who voluntarily provides the SEC with original information that leads to successful enforcement action with more than $1 million in penalties.[15]

---

[13] U.S.S.G. §8C2.5(f)(1).

[14] *See* SEC Release No. 44969, Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 and Commission Statement on the Relationship of Cooperation to Agency Enforcement Decisions (October 23, 2001), available at http://www.sec.gov/litigation/investreport/34-44969.htm.

[15] 17 C.F.R. § 240.21F-3. "Original information" is defined as information that is derived from a whistleblower's independent knowledge or analysis and that is not already known to the SEC nor exclusively derived from the media, a judicial or administrative hearing, or a government report. A whistleblower need not have first-hand knowledge of a potential violation to qualify, however; "independent knowledge" may be gained from "experiences, communications and observations" with others inside or outside of a company. Information obtained from a communication subject to the attorney-client privilege is excluded from the definition of original information. In addition, certain categories of employees, including compliance, audit, and legal personnel who obtain information about a potential violation, are generally excluded from obtaining awards. 17 C.F.R. § 240.21F-4(b).

The incentives to recover a potentially huge reward for reporting on misconduct at a company are perhaps most significant in the FCPA context. Given the recent spate of enforcement actions with fines in excess of $100 million, FCPA whistleblowers in the future could receive payments in the tens of millions of dollars. The FCPA is just one area in which a whistleblower may obtain a significant bounty, however. The whistleblower provisions apply to the full panoply of violations over which the SEC has jurisdiction, including insider trading, Ponzi schemes, and market manipulation. The SEC estimates that it will receive approximately 30,000 tips, or reports of potential violations, per year under the whistleblower program.[16]

From a corporate compliance standpoint, the whistleblower provisions pose a significant problem because they do not require corporate whistleblowers to report their allegations internally through existing compliance channels. Thus, companies now face risks that disgruntled employees or former employees will go straight to the SEC with a tip regarding potential misconduct before informing anyone in the company's compliance or legal department. One possible outcome is that highly developed corporate compliance programs that rely on internal reporting may be circumvented. Even more serious, when a whistleblower reports a tip to the SEC and the matter results in an enforcement action or a criminal case, the company in question likely will not be eligible for a reduced fine under the federal Sentencing Guidelines for voluntarily disclosing the potential problem.[17]

The whistleblower rules do provide that a factor that may increase the amount of an award is "whether, and the extent to which, the whistleblower . . . participated in internal compliance systems."[18] Conversely, if a whistleblower interfered with those systems "to prevent or delay detection," or if a whistleblower made a false statement "that hindered an entity's efforts to detect, investigate, or remediate the reported securities violations," the award likely will be reduced.[19]

In addition, the whistleblower provisions contain a "look back provision" for whistleblowers who initially report information pursuant to a company's internal compliance procedures. If the whistleblower submits the same information to the SEC within 120 days of notifying the company, then the whistleblower will be deemed to have provided the information to the SEC on the date he or she first notified the company.[20] This rule protects the original whistleblower if,

[16] SEC Release No. 34-64545, Implementation of the Whistleblower Provisions of Section 21F of the Securities Exchange Act of 1934 (May 25, 2011), at p. 209, available at http://www.sec.gov/rules/final/2011/34-64545.pdf

[17] See U.S.S.G. §8C2.5(g)(1) (corporation can obtain a reduced fine if, "*prior to an imminent threat of disclosure or government investigation*," it self-reports an offense to "appropriate governmental authorities," cooperates in the investigation, and accepts responsibility for its conduct) (emphasis added).

[18] 17 CFR 240.21F-6(a)(4).

[19] 17 CFR 240.21F-6(b)(3).

[20] 17 C.F.R. § 240.21F-4(c)(3).

during this 120-day period, another whistleblower tips the SEC to the same conduct, provided that the first whistleblower's information was specific and credible. The SEC emphasized that this look back provision is designed to support compliance programs "by allowing employees to take their concerns about possible violations to appropriate company officials first while still preserving their rights under the Commission's whistleblower program."[21]

WHAT COMPANIES CAN DO TO RESPOND TO THESE CHALLENGES

No company can eliminate the risk of an employee committing an FCPA violation. Nor can any company eliminate the risk of an employee or former employee tipping the SEC to a potential violation in hopes of obtaining a whistleblower bounty. But companies can and should consider various steps to deal with the challenges posed by the FCPA and the Dodd-Frank whistleblower provisions.

As an initial matter, and as noted above, companies with international operations should institute robust FCPA compliance programs. These programs should contain, among other things, procedures for due diligence in connection with third party agents, intermediaries and other business partners; employee training; and gift, travel, meal, and entertainment expenses involving foreign officials. In addition, companies should consider instituting several steps to encourage employees or former employees to first report potential violations internally before reporting them to the SEC under the whistleblower program.

First, companies should consider augmenting their employee certification process. As noted above, employee certifications are often used in FCPA compliance programs, and they can be useful in obtaining information from employees about potential violations. In light of the increased risk of whistleblower reports, it may be wise to require employees to certify every quarter or every six months rather than annually. More frequent certifications will increase the odds that a company will learn about potential violations earlier and be better able to address them. This more timely information flow will, in turn, allow companies proactively to investigate issues rather than simply reacting to an SEC request for information about a whistleblower complaint that may ultimately prove meritless. In addition, departing employees should be asked to fill out a certification form asking if they are aware of any conduct in their tenure with the company that might have constituted a violation of the law. Because

---

[21] SEC Release No. 34-64545, Implementation of the Whistleblower Provisions of Section 21F of the Securities Exchange Act of 1934 (May 25, 2011), at 91.

whistleblowers are often disgruntled *former* employees, companies should have departing employees “go on record” about any potential violations.

Second, companies should consider enhancing their training of employees on securities law violations. At least in the FCPA context, such training often is a combination of in-person sessions for new employees paired with the requirement that employees periodically view a video training course on their computers. Naturally, video courses have the advantage of training large numbers of employees in a cost-effective manner. But companies should consider conducting more frequent in-person training in light of the risks imposed by the whistleblower provisions. In the end, nothing encourages internal reporting more effectively than when companies show they have an ethical “tone at the top,” care about compliance, and take allegations of wrongdoing seriously. In-person training is one way to showcase this commitment to compliance.

Third, companies that have not already established dependable, anonymous channels for employees to report suspected violations should do so right away. Such channels typically take the form of hotlines or email tip-lines where employees can anonymously, and without any fear of retaliation, report on potential legal violations by their colleagues. The hotline or tip-line should be widely publicized to all employees, and any reports of potential violations should be investigated promptly.

CONCLUSION

Companies that establish compliance programs or augment existing programs no doubt will incur costs in doing so. However, the benefits of a robust compliance program outweigh the costs. In the FCPA realm, companies with good compliance programs will reduce the risk of a violation occurring and thereby the risk of potentially huge fines being imposed in an enforcement action. In the whistleblower context, money spent on encouraging employees to report suspected violations internally will be well worth it, compared with the far greater costs of dealing with an SEC investigation initiated by a whistleblower complaint.

As the New York Stock Exchange Commission on Corporate Governance recently observed, “Good corporate governance should be integrated with the company’s business strategy and objectives and should not be viewed simply as a compliance obligation separate from the company's long-term business prospects."[22] The challenge for boards of directors and management in the U.S. will be to heed these words amidst a challenging regulatory landscape.

[22] *Report of the New York Stock Exchange Commission on Corporate Governance*, at p. 4, September 23, 2010, available at http://www.nyse.com/pdfs/CCGReport.pdf.

Professional Paper
UDC 658.114:061.238>(44)

Joëlle Simon

COUNTRY REPORT - FRANCE

MEDEF is the largest representative business organisation in France: it represents 800.000 companies from all sectors of economy: industry, services, retail, from all sizes: large, medium and small companies, listed or private companies.

For MEDEF, improving the corporate governance of listed companies is a long term commitment.

When, in 1995, along with another business organisation, AFEP, we took the initiative to publish a code on corporate governance of listed companies, it was a spontaneous move, not prompted by any financial scandal as it was the case in some other countries, like the USA (Lockheed case) or the UK (Maxwell scandal).

This move reflected an intent to respond to the expectations of new shareholders who acquired shares after the privatisations of early 80s and the market opening to foreign investors.

This code called Viénot report named after the president of the working group - set up the five pillars of good corporate governance:

- transparency through disclosure,
- a balanced exercise of powers,
- proper accounting and audit,
- board responsibility,

- and the trademark of corporate governance "*the comply or explain approach*".

At that time, this code was welcomed with some scepticism even among our members. "*It was just a trend coming from abroad*"! But on the contrary, this code heralded the beginning of a gradual and virtuous process, leading to truly far – reaching changes.

Since then, it has become the code of reference of SBF 120 index listed companies and has been amended 6 times until now: in 1999**,** with the 2nd Viénot report, in 2002 with the Bouton report which enhanced information and transparency, in 2003 with the consolidation of all recommendations, and our first recommendations on directors' remuneration, in 2007 and 2008 with our second set of recommendations on directors' remunerations and in 2010 with our recommendation on gender diversity on boards of companies.

It is an on-going process.

As a result, we have now a very demanding set of recommendations, but maybe too far-reaching for small and mi-caps. That explains the initiative taken by an association of midcaps called Middlenext to publish a code with less demanding recommendations for SMEs.

It would be impossible to go through all the provisions of our code: composition, functioning of the boards, committees and so on. So, I will first focus on one major issue from our point of view: directors' remunerations which is still a hot topic in France, secondly I will say on a few words on our last recommendation on gender diversity and finally, I will conclude, in addressing some questions in debate.

OUR RECOMMENDATIONS ON DIRECTORS' REMUNERATION

MEDEF was a pioneer in 1999 in asking for the publication of directors' remuneration on an individual basis before it was imposed in 2001 by the legislator. And, in 2003 and 2007, MEDEF led the way in making very demanding recommendations.

Instead of delving into the details of all those recommendations that could be fastidious - you could refer to our code available on our website both in French and in English (http://mailing.medef.com/adherents/Rapport_2011_AFEP_MEDEF_novembre_2011.pdf) - I will concentrate on the essence of them: the three pillars and will illustrate them with a few examples.

FIRST PILLAR: *Transparency* which is key; our recommendation to supplement disclosed information by standardised tables represents a huge progress in that direction, welcomed by institutional investors.

Those tables give a complete and clear view of what is the remuneration of each director (seven tables: one global and six on the different components of the remuneration): 91.5 of CAC 40 Index listed companies and 88.5 of all SBF 120 Index listed companies used them in 2010.

SECOND PILLAR: *A risk based remuneration* through clear performance objectives. One example to illustrate that point: the exercise by executive directors of the options and the award and acquisition of the performance shares must be related to performance conditions (internal or external performance requirements) that are to be met over a period of several consecutive years: 88 % of CAC 40 Index listed companies comply with that recommendation (this adds to the fact that the performance of the company is in itself a condition to the exercise of the options).

… a risk based remuneration through the acquisition and the holding of a significant number of shares: the board of directors or supervisory board periodically determines the number of shares resulting from the exercise of stock-options or the award of performance shares that the executive directors are required to hold as registered shares until the end of their term of office. The number of the shares so acquired must be material and must increase over time. 94 % of CAC 40 Index listed companies and 90 % of all SBF 120 Index listed companies complied with that recommendation in 2010.

… a risk based remuneration through the prohibition of any termination payment in case of failure: "*No reward for failure*":

termination payments are not allowed for the indemnification of an executive director, unless her or his departure is imposed on such director and linked to a change in control or strategy;

when termination payments meet those conditions, they are in any case conditioned upon demanding performance requirements and should not exceed 2 years of compensation (fixed and variable) and are subject to the related party procedure, that means the agreement of the board and the approval by the general meeting of shareholders;

As a result, only 53 % of CAC 40 Index listed companies now provide for severance payments and 100 % of CAC 40 Index listed companies and 96,5 % of all SBF 120 Index listed companies which provide for such termination payments comply with the threshold, 42 % and 30,5 % with all the conditions.

THIRD PILLAR: No outrageous privileges for executive directors, that means:

- no termination payment in case of retirement,
- no termination payment as a director and as an employee. According to French law it is possible to cumulate an employment contract with an executive director's contract. That is why we recommend to put an end to any employment contract in case of appointment as executive director. As a result, 77 % of executive directors of CAC 40 Index listed companies no longer have an employment contract,
- no discount on the grant of options: 100% of CAC 40 Index listed companies and 95 % of all SBF 120 Index listed companies now comply with this recommendation..

OUR RECOMMENDATION ON GENDER DIVERSITY

Until recently (2009), the percentage of women on boards of listed companies was quite low and the situation has not changed a lot over the last 20 years: in 2009, women on board of listed companies represented 10 % for CAC 40 Index listed companies and 9.1 % for all SBF 120 Index listed companies.

That is why MEDEF, along with another business organisation - AFEP, decided in April 2010 to issue a recommendation for listed companies to improve this situation.

We recommend that each board should have a percentage of:

- at least 20 % of women within a period of 3 years,
- and at least 40 % within a period of 6 years.

We also recommend that those boards that did not have any female members at that time must have nominated a female director after the second general meeting following the publication of our recommendation.

To be completed, in 2008 our president, Mrs Laurence Parisot, made a first attempt to issue such a recommendation, but she had to face a lot of resistance.

As a consequence, the percentage of women on boards of listed companies has then reached 16.3 % for CAC 40 Index listed companies and 12.5 % for all SBF 120 Index listed companies after the 2010 general meetings.

Increasing the proportion of women on boards is part of a more comprehensive move towards diversity: that means breaking the uniformity of board's composition and as a consequence:

- more directors from different backgrounds,
- more non-national directors,
- more women as directors.

As a business organisation, we privilege a soft law approach. But at the beginning of 2011, an Act was passed with the same objectives as our recommendation (with two deadlines in 2014 and in 2017) with a wider scope because the law also applies to large private companies meeting some thresholds (500 employees and a turnover or a balance sheet over 500 million euros). That represents in total more or less 2.000 companies.

Where are we now, after the last general meetings of 2011.Which are the percentages?

- for CAC 40 Index listed companies: 21.1 %,
- for all SBF 120 Index listed companies: 17.2 %
- and for non-listed companies included in the scope of the new legislation: 8.3 %.

This is an illustration of the permanent struggle between self-regulation and legislation in France.

In 1995, when we have published the first edition of our code, French company law and regulation were already very strict and protective with regards to the protection of minority shareholders, the balance between the different powers in the company and the prevention of potential abuses.

One characteristic of French law must be stressed: the prohibition by the law to have more than one third of executive directors on board, which prevent some abuses.

Besides that, we think there is still room for self-regulation, or regulation by professionals.

But each time there is a crisis, and the one we are facing now is particularly severe, self-regulation is challenged.

It is not true to say that self-regulation does not work, the problem is the absence of any regulation, whatever its origin: legislation or self-regulation.

Self-regulation or professional regulation that works if:

- it is not conceived as a way to escape legislation, but as a higher level of ambition than the statutory legislation,
- and if it is well monitored.

There are different enforcement means: disclosure, without no doubt, one of the most powerful ones, monitoring by business organisations and by financial authorities, use of standard forms for reporting.

In France, we now have reached a good balance between legislation and self-regulation, but there still exists a temptation by national and European legislators to add new layers of legislation.

As MEDEF, we think it is important to preserve the main advantage of the "*comply or explain rule*", ie the flexibility and especially for small and mid-caps.

This year, for the 3rd time, we will make public in November our report on the application of our code (This report is now available, but in French only, on our website.).

Compliance rates are high and increase every year: 100 % for numerous recommendations related to the board composition and functioning for CAC 40 Index listed companies and close to 90 % for all SBF 120 Index listed companies.

The French Financial Authority which have recently stressed the fact that we have reached a very good level of corporate governance, will also publish a report by mid-November.

But of course, there is still room for improvement.

CURRENT DEBATE QUESTIONS

I would like to conclude with three questions which are currently debated in France and in Brussels:

- the dissociation of the positions of chairperson of the board and of chief executive officer,
- the "*say on pay*" rule,
- the level of directors' remuneration

The dissociation of the positions of chairperson of the board and of chief executive officer:

This point was raised again by the Green Paper on the EU Corporate Governance Framework published by the European Commission some months ago.

From our point of view, it has not been demonstrated that the dissociation of the positions of chairperson of the board of directors and chief executive officer is, in terms of corporate governance, preferable to a situation where these positions are held by the same person.

This latter solution does not decrease the importance of the role played by the board in the governance of the company.

The existence of non-executive independent directors (and, as regards certain issues, appointment of a vice-chairperson or a lead independent director), the fact that the chairperson and chief executive officer does not participate in certain committees of the board (the remuneration committee for example) or the limits that may be imposed on the powers of the chairperson and chief executive officer, are means enabling the board to fully play its role.

The diversity of governance modes which responds to a need experienced by companies and should be preserved.

According to French law, it is possible for a company to choose between a one tier or a two-tier system and inside the one tier system to opt in for the combination of the functions of chairperson and of CEO or for the dissociation of those positions.

The "say on pay" rule:

Should we introduce the "say on pay" in France? I will answer "no" because we do not need it. Why?

Firstly: According to French law, shareholders already play an important role on directors' remuneration area:

- the general meeting of shareholders determines the global amount of non-executive remuneration,
- it must authorise the board of directors or the management board to grant options (because it increases the capital),
- it decides on termination payment on the basis of related parties agreements' procedure.

So we already are beyond the objectives of the "say on pay" which are, if I understand well, and I quote Sir Adrian Cadbury: "not about shareholders having control over the process, but about increasing transparency and promoting dialogue".

Secondly: Our Code recommends that the general meeting of shareholders be "an opportunity for a genuine and open discussion with the shareholders" and "that a very complete information must be provided to shareholders so that they can have a clear view, not only of the individual compensation paid to executive directors, but also of the policy applied by the company in order to determine the compensation paid".

Moreover, the European Commission report on the implementation of the recommendation on directors' remuneration, considers the presentation of the annual report to the general meeting of shareholders as complying with its recommendation.

So a formal vote either consultative either compulsory would not add any more value.

At last, there are some other arguments:

It is up to the board of directors to nominate executive directors, so it is logical that it determines the remuneration which is part of the negotiation.

The system would not be feasible, because the remuneration is composed of different elements. Should we, in this case, ask for several resolutions? What would happen in case of a negative vote on some elements of remuneration which is a global package?

The level of directors' remuneration:

It is still a hot topic in France especially in the campaign for the Presidency of French Republic.

From our point of view, it does not make any sense to determine a level in absolute numbers, or to limit the maximum remuneration by reference to a multiple of the minimum wage.

As you may know, the Dodd Frank Act has imposed the publication of the ratio between the CEO's remuneration and the average remuneration of employees for listed companies.

We have privileged a different approach, our Code states that the boards and committees must take into account the following principles:

- consistency, the executive directors' compensation must be determined in a manner consistent with that of the other officers and employees of the company,
- reasonableness, the method of determining the compensation must be balanced and take into account at the same time : the company's general interest, market practices and officer performance.

And last September, our president asked for moderation in the level of top executive directors' remuneration.

To conclude, there is no doubt that corporate governance codes could be challenged during the months to come, especially on sensitive issues as the directors' remuneration, but we really think that soft law has still an added value for stakeholders.

Professional Paper
UDC 005.7(497.7)

Verica Hadzi Vasileva-Markovska

CORPORATE GOVERNANCE IN THE REPUBLIC OF MACEDONIA

Abstract

The specificities of the development of the corporate governance structures and practices in the Republic of Macedonia can be sought among the following situations: First, the privatization in Macedonia in the 1990s was conducted in a manner that many of the incumbent management and employees became shareholders of the companies that were privatized. This brought forward a rather dispersed ownership structure of many companies in the country. Some estimates were that by the end of the 1990s there were 300 thousand shareholders in Macedonia. This number decreased to 255 thousand in 2004 and even 105 thousand in 2007. Second, having so many shareholders, who are also employees in the companies, makes them be confused about their primary role in the company. There will be a certain time passed until people can successfully play both roles in the company: as employees and as shareholders. Third, similarly to the previous, but now on the management level, there is not sufficient distinction between ownership and control in the company. There are still cases of no separation between the top positions in the companies (especially CEO and President of the Board), which has consequences to the control and supervision in the company. Fourth, the composition of the boards of directors – especially the non-executive directors and of the supervisory boards is far from the best practices. These are frequently people who have not enough competence, experience and skills, they are often familiar to, or even controlled by the dominant shareholders or the managers, decreasing thus the effectiveness of the supervision in the companies. In state owned companies, this is also complicated by the partisan policy in nominating executive and non-executive directors in corporate boards. This was the main reason to feel the need for establishing the Institute of Director that would assist in the promotion of the role of non-executive directors in companies. Fifth, the transparency and disclosure practices of the companies' financial performance and position in Macedonia have gone through a long process of improving. The companies were reluctant to disclose their financial statement in line with IFRS requirement.

Auditing profession was also slower to get organized in comparison to some other countries in the region. It is only several years ago that the Macedonian Institute of Auditors was established and just recently it became an associate member of IFAC. This is supposed to increase the transparency and disclosure practices in Macedonia.

The corporate governance in the Republic of Macedonia gained in significance in parallel with the process of privatization. This is when the companies started to get privatized and it became obvious that for the general economic development and growth it was not only important to denationalize the state-owned companies, but it was also important to have a proper system of corporate governance, which would preserve and add value to the companies. It became obvious that the type of management control, supervision and reporting and the transparency of the whole process does matter for the wellbeing of the companies.

And in fact, the type of privatization did bring some specificities of the development of the corporate governance structures and practices in the Republic of Macedonia. The privatization in Macedonia in the 1990s was conducted in a manner that many of the incumbent management and employees became shareholders of the companies that were privatized. This brought forward a rather dispersed ownership structure of many companies in the country. Some estimates were that by the end of the 1990s there were 300 thousand shareholders in Macedonia. This number decreased to 255 thousand in 2004 and even to 105 thousand in 2007. The trend of decreasing the numbers seems to have coincided with the economic prosperity and the period of more active capital market, which was at its peak in period between 2005 and 2008.

The second specificity has to deal with the fact that so many shareholders, who are also employees in the companies, makes them be confused about their primary role in the company. There will be certain time passed until people would be able to successfully play both roles in the company: as employees and as shareholders.

Third specificity is similar to the previous one, but now on the management level: there is not sufficient distinction between ownership and control in the company. There are still cases of no separation between the top positions in the companies (especially CEO and President of the Board), which has consequences to the control and supervision in the company.

The fourth specificity relates to the composition of the boards of directors – especially the non-executive directors and of the supervisory boards is far from the best practices. These are frequently people who have not enough competence, experience and skills, they are often familiar to, or even controlled by the dominant shareholders or the managers, decreasing thus the effectiveness of the supervision in the companies. In state owned companies, on the other hand, this is also complicated by the partisan policy in nominating executive and non-executive directors in corporate boards.

Finally, there is one more specificity. This is connected to the disclosure and transparency principle. The companies were reluctant to disclose much of their internal information. They were not keen in publishing their financial statements in line with IFRS. The auditing profession was in existence since the old Yugoslav system. Still, when it came to change and accept the modern principle of organizing of the profession, Macedonian auditors were among the last in the region to comply. There were several efforts to organize the Institute of auditors in the Republic of Macedonia and finally, this effort was successful only in 2006. The Macedonian Institute of Auditors was established and just recently (in 2011) it became an associate member of IFAC. It is now developing its control function in order to make sure that the IFAC and other professional principles related to accounting and audit are being implemented properly. On the other hand, there is also a Council for Audit Supervision, which is organized mainly by non-auditors. It was first organized in 2006, under the Ministry of Finance, but later on, 2009, it was supposed to get organized as a non-governmental organization but majority financed by the state budget. The President of the Council is to be nominated by the Ministry of Finance and this has not happened since 2009, which made the Council be inactive since then. Once it starts operating properly, the audit profession will have two levels of control – within the profession, and above the profession, from the socially broader aspect.

There were several researches that were conducted in the Republic of Macedonia on the topic of corporate governance. This topic was commissioned to be analyzed by EBRD, IBRD and IMF, especially through the Report on Observance of Standards and Codes (ROSC) report, IFC, Foundation for Open Society in Macedonia, OECD, USAID etc. They were all assessing to some extent what the corporate governance status in the Republic of Macedonia was. Many of them and more specifically the ROSC Report in 2005 examined the level of achievement of the 6 OECD corporate governance principles in the Republic of Macedonia:

- Framework for effective corporate governance;
- Shareholders rights and basic ownership functions;
- Equitable treatment of shareholders;
- Stakeholders’ role in corporate governance;
- Disclosure and transparency; and
- Board of directors’ responsibility.

The ROSC (Corporate GovernanceCountry Assessment, Report on Observance of Standards and Codes (ROSC). Corporate Governance. World Bank, 2005) report for example state that most of the principles ranged within the partially observed or largely observed area. Similar were the conclusions of the other reports. The EBRD analysis (Commercial Laws of FYR Macedonia, April 2010, An Assessment by The EBRD) considered that the country was in medium compliance with best practices. Most of the reports conclude that the situation is much better “by book”, however poor “by actions”.

The Government has reacted on many of the findings of various reports and analyses. And indeed the overall business climate, the corporate governance being part of it, has been assessed by the World Bank Doing Business Report as highly friendly: Macedonia ranked 22nd on the 2012 list (http://www.doingbusiness.org/data/exploreeconomies/macedonia,-fyr) out of the 183 world economies. It has also been complimented for fast progressing up the list for several years in a row.

Some recent improvements are well observed. These are mainly in the field of internal audit and audit committees:

- Internal audit has been made obligatory for all public companies since 2010 and prior to this it has been obligatory for the banks. The banks are generally known to have much better corporate governance than other corporate sector in Macedonia.
- Audit committees have been made obligatory for banks in the Law on Banks 2007 and for all companies, which are obliged to comply with public disclosure rules in the Audit Law of 2010. It is to be mentioned, though, that this provision of the Law came unnoticed and the companies are still not in compliance with it. The reason for it is probably the fact that the rule has not come from the Company Law but from the Audit Law. This also demonstrates how the various laws may have diverging and thus confusing provisions.
- Overall disclosure rules but also practices have been constantly improving.

Still, there are some aspects that need improvement. The most problematic areas in the corporate governance field, still, are the following:

First, the area of disclosure and transparency. This relates mainly to the area of the relatively late institution of the Institute of Certified Auditors and the fact that it has become an associate member of IFAC only this year. Out of the profession supervision to auditors, as discussed preciously, is improving but is still not sufficient and this system needs to be better developed.

Second, Board of directors’ responsibilities seems to be one of the most problematic areas. Boards of directors – the non-executive parts of them and the supervisory boards are usually nominated by the management and the Assembly simply elects them. This brings forward an unnatural relationship between the executive and non-executive directors, or between the board of directors and the supervisory board. The non-executive members are thus made dependent on the executive, rather than the other way around – the executives to be nominated and supervised by the non-executive board members. They are not sufficiently independent from the executive board members. In addition to this, they seem that they are not aware of their responsibilities and thus of the risks they run by not complying with laws and best practices. There are not so rare cases in which Board members are not sufficiently professional. Sometimes they feel intimidated by the Management. In the state owned companies and in the public utility companies owned by the state, this situation tends to be even more complicated because of the influence of the parties on the nomination of companies' board members.

The major law governing aspects of corporate governance is the Company Law. The first law was enacted relatively late in the transition process, only in 1996. It had many inconsistencies and had to be changed. This was done in 2004, when the new Company Law was passed by the Macedonian Parliament. This is considered to satisfy the needs of the private sector and to be a good framework for good corporate governance in the country. There are other laws which regulate specific aspects of corporate governance, such as the Securities Law, the Takeover Law, the Bankruptcy Law, the Audit Law, the Law on Banks, the Law on Supervision of Insurance, the Law on Investment Funds etc. There are also Rules for Listing on the Macedonian Stock Exchange, the Corporate Governance Code and similar by-laws which deeper regulate the corporate governance area. The legislation is considered to be highly harmonized with the EU acquis. The implementation in practice still needs improvement.

There are several institutions involved in developing and maintaining the corporate governance framework. Probably the crucial ones are the Security Exchange Commission, the Macedonian Stock Exchange and the Central Depositary. There are other organizations, such as Institute of Directors, Association for protection of shareholders' rights "Shareholder 2001", Corporate Governance Council, Institute of Auditors, Coucil for Supervision of Audit, Chamber of valuators etc.

Macedonian legislation defines the following forms of companies:

- General Partnership;
- Limited Partnership;
- Limited Liability Company;
- Joint Stock Company; and
- Limited Partnership by Shares.

The most commonly used ones are the Limited Liability Company and the Joint Stock Company. More than 95% (Corporate Governance Manual, Institute of Directors, IFC, Skopje, 2011) of the companies in Macedonia are registered as limited liability companies. There are 479 companies registered as joint stock companies. A hundred and fifty four joint stock companies belong to the group of companies, which have special obligation to disclose data (so called publicly held companies). The Security Exchange Commission has a special register for them. The securities of 32 companies are listed on the Macedonian Stock Exchange, two of which are listed on the super listing. In terms of corporate governance, the companies that attract most attention are the joint stock companies. The various features of these companies are presented below (Corporate Governance Manual, Institute of Directors, IFC, Skopje, 2011):

Feature	**Listed companies**		**Publicly held companies**	**Other companies**
	Super listing	**Stock Exchange**		
No of shareholders	At least 200	At least 100	At least 50	At least 1
Foundation capital	At least 10 mil. €	At least 0,5 mil. €	At least 1 mil. €	At least 25/50 thousand €
Shares for public	At least 20%	At least 15%	No requirement	No requirement
Scope of disclosure	Maximum: Corporate Governance Code is obligatory	Maximum: Corporate Governance Code is obligatory	According to the Company Law and Securities Law	

The main bodies of the joint stock companies are the shareholders' Assembly and the managing body/ies. The Assembly is not a managing body. The type of managing bodies depends on whether the Company has a one-tier or two-tier managing system.

The one-tier managing system has a Board of Directors and a Director. The Board of Directors can have at least 3 and at most 15 persons. They are nominated by the shareholders' Assembly. The Board of Directors has two types of members: executive and non-executive members of the Board. One fourth of the non-executive members need to be independent members. The non-executive members control and supervise the work of the executive members of the Board. The non-executive members nominate the President of the Board from the non-executive members.

The two-tier system has two managing bodies: Supervisory Board and Managing Board. The Supervisory Board members are nominated by the Shareholders' Assembly. The Supervisory Board can have between 3 and 11 members. One fourth of the non-executive members need to be independent members. The Supervisory Board has the leading role within the corporate governance system. The Supervisory Board defines the mission and the objectives of the company, it takes care of the interest of the company; it takes care of the protection of the shareholders and controls and supervises the members of the Managing Board and the managers of the company. The Managing Board comprises between 3 and 11 members. In smaller companies, with the foundation capital being lower than 150.000 €, there can be only a Director, instead of the whole Managing Board. The Supervisory Board nominates the members of the Managing Board, one of which will be nominated for the President. The Supervisory Board can revoke the President of the Managing Board at any time.

The managing body, or the Supervisory Board of the Company can decide to establish various committees, the activities of which will be to assist in the decision making process and the information that will nurture the decision making process. The Company Law recommends that such committees are established and the Corporate Governance Code defines which committees might be established: audit committee, remunerations and rewards committee and elections and nominations committee. The Banking Law provides for mandatory establishment of audit committee in the banks. As of 2010, the Audit Law provides for mandatory establishment of audit committee in all joint stock companies, which have special disclosure obligation. The majority of the Audit Committee should be members of the Supervisory Board. The Audit Committee should have at least five members. At least one of them should be experienced in audit and accounting. As already discussed, the provision for the Audit Committee was not transferred to the Company Law, so that it has still not been implemented.

In addition to the committees, the companies can nominate persons, internal legal advisors, or corporate secretaries that would take care about proper implementation of the legal and statutory requirements of the managing bodies. This role has practically not been developed in Macedonia yet.

The regulation on management and governance defined in laws and by-laws is very much harmonized with the best practices. However, in practice, there are deviations and the board responsibilities area is one such area. On “paper” everything is as should be. The major drawback is the fact that the non-executive directors and the members of the supervisory boards seem not to be aware of their responsibilities and many of them do not possess the skills and the expertise on how to perform their duties for the wellbeing of the companies they are governing.

This was the main reason to feel the need for establishing the Institute of Director that would assist in the promotion of the role of non-executive directors and members of the supervisory boards in companies. The Institute of Directors of the Republic of Macedonia has recognized the need for improving the situation with the non-executive boards and that improving their capabilities may enhance the overall companies’ performance. The Institute was established in 2009. It currently has almost 50 members, belonging to companies of different industries, sizes and regions in Macedonia. The Institute has been largely supported by IFC and its corporate governance department.

The Institute’s mission is that the Institute of Directors in Macedonia is dedicated to creating a positive impact on the economy and the society by promoting professional directorship and good governance. In the focus of its activities is to support Boards of Directors and Supervisory Boards in order to assist them to add value to their strategic decisions.

General goals of the Institute of Directors are the following:

- To promote respect for the role of director,
- To protect the rights of Macedonian directors,
- To improve the professionalism, expertise and status of Macedonian directors.

It specific goals have been defined as:

- Preparation of Manuals related to the rights and obligations of members of the Supervisory Boards and non-executive and executive members of the Boards of the companies,
- Organization of trainings/workshops,
- Cooperation with similar institutions abroad,
- Organization of visits to international meetings of institutes,
- Ensuring that the Code of Conduct for application of best practices in the corporate governance is properly adhered to by the Institute's members,
- Promotion of the Institute of Directors and its mission,
- Organization of conferences,
- Improvement of the capacity of the persons who provide professional support to the Boards of Directors and Supervisory Boards (especially company secretaries and internal legal advisors) etc.

In order to conduct its mission, the Institute organizes workshops, trainings, it performs corporate governance assessments and publishes various types of publications. The most recent one was the update of the Corporate Governance Guide, which was published in the end of 2011. The Institute is encountering certain problems, such as the following: the need for the IOD's services has not been widely recognized, if board members do not fully understand their responsibilities and the risks they run if they do not comply with the regulation and with the best practices. Very often, the non-executive board members and the supervisory boards are considered as a "necessary evil" and the companies are not happy to invest in them. Public awareness for the need of improvement is still low and the Institute is trying to increase it.

Review
UDC 658.114/.115:174>+005.7

Marijan Cingula
Mislav Ante Omazić
Marli Gonan Božac

CORPORATE SOCIAL RESPONSIBILITY OR CORPORATE GOVERNANCE – WHAT'S COMING FIRST?

Abstract

Perhaps never in the history has so much been written about the role of business in modern society, role that is multi and cross dimensional, since the factors that are influencing environment are changing faster than ever before. Nowadays it is true more than ever that only those that effectively and efficiently adapt to needs coming from society, can and will survive in the future. The challenge for modern corporate leaders is to know how to meet the company's obligations to stakeholders without compromising the basic need to earn a return to its owners/shareholders. In that sense unlike any other time in our history, corporate social responsibility and corporate governance have a real impact upon each and every decision maker that operates on modern market. This paper addresses the complex environment of corporate social responsibility and corporate governance in today's organization. It explores how and why responsibilities of owners, leaders, managers and employees to their organization, other stakeholders, the environment, and wider society have changed since principle organizational goal moved from profit maximization to profit optimization. Throughout this paper we tried to emphasize linkage between corporate social responsibility and corporate governance where we assumed that their fiduciary and moral responsibilities are basis for sustainable relationship towards their stakeholders and sustainable business growth in a globalizing environment.

INTRODUCTION

A couple of years ago some claimed that capitalism is at the crossroads (Hart, S., 2005), others asked if a corporation has a conscience (Goodpaster, K. E., Mathews, J. B., 1982) and if things can continues like this (Hiles, A., 2007) even before crises started? It is true that we have grown to live in tough times and the companies do have a different role in a modern society. From issues related to current financial crisis that is likely to become crises of modern way of life, to impact of values on daily organizational decision-making process that creates our work environments, those things matter. So there is no wonder why an Internet search of such key terms as system of values, business purpose, business ethics, corporate responsibility, corporate governance, reputation management and sustainable development yields page after page of references to recent articles in top business journals, of both the popular and scholarly persuasions. Another trend is that these subjects have moved from the academic studies to the boardrooms. Corporate social responsibility (CSR) and corporate governance (CG) are incorporated into every aspect of business strategy and decision-making since it became essence of sustainable success.

Hypothetic question opens real dilemma for modern companies and their influence on society. Fact is that role of corporations changed and they became most powerful institutions of modern society. That impact is balanced between social, environmental and economical elements. In that sense CSR is context based way of progressive acting and/or particular behaviour of some companies and their representatives. Whereas CG is rather firmly framed set of mechanisms that have principle goal to control system. There is a strong mutual interference between two categories of contemporary behaviour: corporate governance is result of socially responsible activities but simultaneously the higher level of development of corporate governance in leading business sectors can significantly improve the social responsibility, in general. In this paper authors tried to find the answers on several important questions regarding that causality. First, they tried to define and deal with different aspects of social responsibility trying to identify internal and external factor of private business that do have highest influence. Since the definitional confusion might potentially be a significant problem (Dahlsrud, A., 2008). In case if competing definitions have diverging biases, all parties in interest will talk and think about CSR and CG differently and thus prevent productive engagements. Second, they try to find out if the corporate governance is only external factor for modern company; introduced by state and industry standards, or it can be seen as a competitive advantage. Finally, authors try to put lighter on interaction between the two, CSR and CG.The comprehension of relationship between CSR and CG also becomes more complicated due to the inseparability of this relationship from its environment (Mahmood, Z., Riaz, Z., 2008).

THE TERM, INFLUENCE AND IMPORTANCE OF CORPORATE GOVERNANCE

In the fast changing world it is harder than ever to balance conflicting stakeholder demands in economic advancement, improvement, and sustainable development of the most powerful market entity, the company.Corporate governance(CG) can be defined as a set of different processes, affecting the way a company is administrated and controlled. It can be also seen as the mix of internal and external factors building the relationship among owners and professional executives who have mutual responsibility for the corporation and for the stakeholders. CG prompts companies to exercise tight internal control mechanisms and toprotect primary shareholder's/owner's rights since they have provided company with capital. Corporate governance may also be interpreted as a reaction to agency theory issues, associated with the separation between owners and managers and their rights. It is important to emphasize that problems are not restricted exclusively to the interaction between managers and owners, but may also occur in the relations among owners, especially when they are very heterogeneous in terms of their specific relevance regarding their influence on decision-making process. Problems may occur also among and between other stakeholders since company's resources are not limitless. There is a CG problem whenever one or more stakeholders coordinate their actions in order to increase their benefits at the expense of the benefits of the other stakeholders. The main internal processes, building the corporate governance set, refer to the financial and organizational aspects, while external factors include international and national standards, legal framework and ethical rules. Standardization of corporate governance includes the transnational general principles and specific national legal, financial and ethical framework for top-level managers in private and public sectors. Good CG program in its essence is all about making better decisions for the long-term health of the company.

In a market economy a company is interconnected and has many relations, implicit and explicit, with many parties in interest, who from time to time may take an interest in, and be in a position to influence, the company’s goals and operations. The general principles of corporate governance were introduced by the Organization for Economic Co-operation and Development (OECD) in 1999 and reviewed in 2004 (OECD, 2004). They have become an internationally accepted benchmark for owners, policy makers, professional managers, investors, corporations and other stakeholders worldwide. The main purpose of implementing the Principles was to improve business administration and ethical standards in modern companies by providing specific guidance for legislative and regulatory initiatives, on national level, in both OECD and non-OECD countries. The Principles should develop a culture and values for professionals and other stakeholders by supporting ethical behaviour on which well functioning markets depend. One of the most important milestones in the history of Principles is well known Cadbury Report (Committee on the Financial Aspects of Corporate Governance, 1992). Acceptance of the report's findings in early 90s marked an important advance in the process of establishing corporate standards, not only in Great Britain but in all developed world as well. The essential of the recommendations is a Code of Best Practice designed to achieve the necessary high standards of corporate behaviour, for the companies listed at the London Stock Exchange. Furthermore, the ethical standards should extend to all companies registered in the UK, while today these standards are recognizable in all ethical codes worldwide.

If the power shift is to succeed, if deregulation and privatization are to grow, corporations will exert more self-restraint and greater self-discipline, substituting self-policing for government regulation and moderating the pursuit of economic gain with stronger ethical restraint (Wilson, I., 2000). We are witnessing another trend in public consciousness after financial meltdown in 2008 – a greater propensity to expand the scope of corporate liability and hold business organizations more responsible for more and more consequences, for individuals and society, for the products and services they sell. CG is more relevant than ever in the context of economic crisis. It can help to build (and rebuild) trust in business, which is vital for the health of Europe's social market economy. It can also point the way to new forms of value of creation based on addressing societal challenges, which may represent a way out of the crisis. The idea of the single market for 21st century Europe, stresses the need for the continuous improvement of the legal framework conditions for companies and their businesses.

The relationship between a company and its stakeholders is sophisticated and only in some aspects specifically defined in law, but it is often appropriate to require companies to take into account a wider range of interests than shareholders alone. Issues of corporate governance are usually regulated mainly by two sets of laws, company law and securities law. In addition, the bankruptcy law and labor law have also an impact on the corporate governance framework.

By the end of 1990s, a single metric of corporate performance, shareholder value, overshadowed all the others and became the focus of most CEOs and their boards. Judging solely by this metric, many boards were apparently doing their job well. An exuberant stock market and a few corporate stars reinforced this focus on shareholder value. No wonder that most managers saw their primary role as enhancing shareholder value (Conger, J. A., Lawler, E. E. III, Finegold D. L.2001). However, as we entered a new millennium, it is a good time to question whether the fascination with shareholder value was misplaced or perhaps overdone, and whether it has actually led to more effective boards. In that sense European approach to the corporate governance development tends to stress the importance of dynamic and flexible company law. Legal corporate governance framework is essential for a modern, dynamic, interconnected industrialized society, such as European market tends to become. If the company law is good and corporate governance practice is standardized according to stakeholders' expectations, the real economy should develop efficient and competitive business organizations. Such an effective and active approach to the regulation on national and global level will help to strengthen stakeholders' rights and third parties protection, which is a constituent part of CSR.

THE TERM, INFLUENCE AND IMPORTANCE OF SOCIAL RESPONSIBILITY

It is clear that the mercenary model of management, where greed is good and only numbers count came to its end. Working people are not merely human "resources" who must be paid less so that executives can be paid more, that type of acting/thinking is antisocial that it will doom us if we don't doom it first (Mintzberg, H., 1999). Businesses are realizing that gaining short-term profits at the expense of social responsibility is not likely to lead to longer-term viability (Hopkins, M., 2003). The CSR typically defines stakeholders more broadly and is more concerned with the company's responsibility to the society without any tight regulation system. Many describe corporate social responsibility as voluntarily acting beyond law to achieve economical, social and environmental objectives (Visser, W., Matten, D., Pohl, M., Tolhurst, N., 2007; McBarnet, D, Voiculescu, A., Campbell, T., 2007; Crane, A., McWilliams, A., Matten, D., Moon, J., Siegel, D. S., 2008). Such an approach recognizes an informal contractual bond between business and society, whereby society provides essential resources to businesses in exchange for social benefits. There are a number of financial ratios and other benchmarks that can be used to document the questionable future company's role within a society after the formal recession has ended (Kumar, S., Tiwari, R., 2011). Managers must engage, and firms must hire managers with the ability to do more than just manage the financial issues (Kemper, A., Martin, R. L., 2011). Enron's bankruptcy, bribery scandals surfacing in Siemens AG and many other German companies like Volkswagen, BP's oil spill in the Gulf of Mexico, unwinding of Bernie Madoff's scandal, Lehman Brothers Repo 105, group effort of big American banks and politicians known also as a ForeclosureGate, and many other scandals have all proved that we are just 'humans', and eroded trust in the ability of business to behave and act responsibly even further. Such developments have challenged the effectiveness of the voluntary approach to CSRA commonsense belief in CSR is that the companies have to be able to "do well by doing good" or how our corporation can use some resources to make positive impact to our society. Corporate social responsibility is developed around the idea that business in general has a responsibility to serve the society as well as the interests of its owners/shareholders. CSR in its core brings together business interests with interests of society (Hopkins, M., 2003; Baller, J., de Bry, F., 2003). In that sense the stakeholder theory offers the clearest perspective on these issues. In developing their business propositions, managers must identify all stakeholder groups and weigh their relative rights and abilities to affect the firm's success.

The present-day conception of CSR implies that companies voluntarily integrate social and environmental concerns in their operations and interaction with stakeholders.The European Commission has previously defined CSR as a concept whereby companies integrate social and environmental concerns in their business operations and in their interaction with their stakeholders on a voluntary basis (European Commission, 2001). In 2011 the Commission puts forward a new definition of CSR as the responsibility of enterprises for their impacts on society (European Commission, 2011).Although it looks like rather general definition it is important to recognize that previously described respect for applicable legislation, and for collective agreements between social partners, is a prerequisite for meeting that responsibility. Therefore for many modern companies it is no longer sufficient just to produce quality products and provide distinctive services to their clients. Companies now need to consider the wider social and environmental consequences of their action (McWilliams, A., Siegel, D., 2001). To fully meet their corporate social responsibility, legal entities should have in place a process to integrate social, environmental, ethical, human rights, diversity, consumer and other concerns into their business models and core strategy in close collaboration with their stakeholders, with the aim of maximizing the creation of shared value for their owners/shareholders and for their other stakeholders and society at large, on one hand and on the other, identifying, preventing and mitigating their possible adverse impacts. The challenge for strategic managers is to know how to meet the company's obligations to stakeholders without compromising the basic need to earn a return to its owners.

In recent years, business leaders have begun to get a clearer understanding of the appropriate role of CSR and its effect on financial performance. What strategic managers really need is a model that they can use to guide them in selecting social initiatives and trough which they can exploit their companies' core competencies for achieving the maximum positive impact.

According to European legislative, CSR is not only a way to control the company. It is a concept whereby companies integrate social and environmental concerns in their business operations and in their interaction with their stakeholders on a voluntary basis. It is about enterprises deciding to go beyond minimum legal requirements and obligations stemming from collective agreements in order to address societal needs. Through CSR, enterprises of all sizes, in cooperation with their stakeholders, can help to reconcile economic, social and environmental ambitions. As such, CSR has become an increasingly important concept both globally and within the EU, and is part of the debate about globalization, competitiveness and sustainability. In Europe, the promotion of CSR reflects the need to defend common values and increase the sense of solidarity and cohesion

(European Commission, 2011). It is very optimistic that European leaders have recognized how CSR is essential for sustainable development while increasing not only ethical behaviour, but also innovative potential and competitiveness. In that sense all political leaders, and top-level managers together with their key stakeholders, must put their energy in building business environment that go beyond existing minimum legal requirements.

However, no matter which definition is chosen, all the above-mentioned share the responsibility of the company in society and creation of value added activities within its business model. It is a primary set of strategic activities that have, as the final result, mutual benefit for the company and for certain social groups. Some companies are proactive in their approach to CSR, making it an integral part of their values and by integrating it into their vision and mission. According to Pearce II and Robinson (2011), businesses adopt CSR due to three broad trends: the resurgence of environmentalism, increasing buyer power, and the globalization of business. The dynamics between CSR and success is complex. A corporation has different interwoven objectives: economic and social. If the objective of a corporation is to maintain long-term profitability, then all the economic costs and benefits will be quantified, however, the social ones do not quantify easily. In addition, managers have their own objectives that may not be compatible with maximizing long-term shareholder wealth (Tipurić, ed., 2008). Changing societal expectations have caused firms to consider more carefully their wider social responsibilities, not only out of altruistic reasons, but also because of the need to consider the potential impact of their policies on stakeholder relationships. This should be even more critical during precarious economic climates (Lacey, R., Kennett-Hensel, P. A. 2010).

CSR follows from a decision by management to expand traditional governance arrangements to include accountability to the full range of stakeholders noted above. CSR in its core brings together business interests with interests of society (Hopkins, M., 2003; Baller, J., de Bry, F., 2003). It is not static and linear concept, but the process of continuous negotiation and redefinition of what is feasible. CSR follows from a decision by management to expand traditional governance arrangements to include accountability to the full range of stakeholders noted above. CSR is not static and linear concept, but the process of continuous negotiation and redefinition of what is feasible.

A century of debate over the proper role of CSR as a company activity that would benefit the society, on top of legislation and directly expressed interests of owners/shareholders, can today be reduced to a core task of strategic managers in terms of establishing a balanced CSR commitment. Valuable partnership and the collaborative approach are the foundation for the effective CSR initiatives. CSR however, is not a universal solution for traditional market conflicts, and this concept is not a substitute for public policy, but CSR can contribute to a great number of business and public objectives, such as:

- more integrated and socially sensitive labour market;
- investment in education and skills development, support to life-long learning;
- improvements in public health;
- better innovation performance in order to resolve existing social problems;
- a more rational use of natural resources and more responsible environmental policy;
- better image of business and entrepreneurs in society, helping to achieve more favorable attitudes towards entrepreneurship;
- greater respect for human rights and poverty reduction.

Some authors emphasize a significant positive impact of CSR in the implementation of systematic activities that examine the impact of factors on the success that future operations have on the organisation (Black, L. D., Härtel, C. E. J., 2004) and therefore it is necessary for organisation to embrace it as a basis for strategic development with no hidden intentions (Hollender, J., Breen, B., 2010). Therefore CSR is generally accepted as a base model to achieve competitive advantage among EU economies because it creates conditions within the business environment where business organisation is perceived as a synergy vehicle that creates and maintains sustainable growth and development. It comprises activities that ensure early adaptation to market needs while avoiding risks and meeting the expectations of a wide range of stakeholders. Business paradigm has changed from profit maximization to company's responsibilities to a broad range of stakeholders including employees, customers, clients, investors, suppliers, unions, community members, citizens and environment in general. In order to improve corporate social responsibility in public and private companies, Commission has identified a number of factors that will help to further increase theimpact of its CSR policy therefore some actions are promoted within the European Union (European Commission, 2011):

- a balanced multi-stakeholder approach that takes account of the views of companies, civil sector and other non-business stakeholders, and Member States;
- better clarification what is expected of business entities, and to make the EUdefinition of CSR consistent with new and updated international principles andguidelines;
- systematic promotion of market rewards for responsible business conduct, includinginvestment policy and public procurement;
- self- and co-regulation schemes, which are an important meansby which business entities seek to meet their social responsibility;
- proactive focus on company transparency on social and environmental issues fromthe point of view of all stakeholders, including business organizations themselves;

- greater attention to human right issues, which have become asignificantly more prominent aspect of CSR;
- acknowledgement of the role that complementary regulation plays in creating an business environment more conducive to enterprises voluntarily meeting their responsibility.

Although the European political forums try to promote Europe as a pole of excellence on CSR and build a European alliance for CSR, there are some other opinions regarding their volountarity.The International Federation for Human Rights (FIDH) and Amnesty International express their disappointment with lack of a firm regulatory framework to ensure accountability by all companies. They suggest establishing the consistent regulatory framework that complements the voluntary aspect of corporate responsibility with a common system for corporate accountability built on national level (Madelin, A., 2008). Within the EU, Member States have different systems of corporate governance, which reflect their different cultures and the various views about the roles of corporations and the way in which their industry should operate.Corporate social responsibility is multi task set of relationship between human individuals, business organizations and other institutions on national and international level. It is not easy to define standards for different national traditions and cultures, but without the general agreement on core values there is no way to achieve ethical approach to business activities. Even when national state, or international community, formally implements a legal framework for ethical behaviour, all institutions and individuals should be controlled and forced to accept principles of common good in business, social and environmental matters.

TWO SIDES OF THE SAME COIN

Striving toward the business profit, creative approach to problem solving, business initiative, and taking risks, are all widely accepted, traditional coats of responsible leadership, which do not become questionable because of the infusion with social factors. This renaissance of interest in the topic is also reflected in a bumper crop of books published during the last year, the quality of which runs the gamut from the sublimely inspiring to the patently delusional. It is longitudinal true that specific element of the market economy dies every day and is replaced by something new (Hawken, P., 1983). Globalization, enforced and enabled foremost by high-speed developments in technology, has had a greater impact on society, environmental awareness among broader public and information sharingon social networks, holding companies accountable 24/7. Power shift occurred and recent protests on Wall Street proved that public does not hold only politicians responsible for their wellbeing but also businessman. We are witnessing that in the western dominated economies, capitalism has yielded way to a new global order in which no one country or region can enjoy an undisputed advantage. This time of limitless possibilities goes in hand with responsibility for that world. Yet we also face serious societal and ecological challenges which, if not addressed urgently and properly, will limit the extent to which we can realize those opportunities. CSR and CG are not new ideas, but corporations still struggle to apply it to their own circumstances failing to realize that they should measure success not in a single, shareholder dimension. There are proofs that increasingly, people in chargeare starting see both as a business proposition. CG mechanism can prevent illegal actions against stakeholders whereas CSR can avert the activities, which are lawful but inapt due to their implications for stakeholders and society (Beltratti, A., 2005).While CG was generally conceived as establishing a basic framework of stewardship and trusteeship, CSR was conceived as the outward expression or manifestation of internal CG policies and principles (Jamali, D., Safieddine, A. M., Rabbath, M., 2008).As such, companies are encouraged to promote accountability, fairness, transparency, honesty and value based behaviour in all their dealings and decisions.

Much of the previous literature has researched and discussed CG and CSR independently, as being unrelated accountability models, whose guidelines, reporting standards and oversight mechanisms have evolved separately (Bhimani, A.,Soonawalla, K., 2005). However, Jamali, Safieddineand Rabbath (2008) believe that CG and CSR are strongly and intricately connected, and that previous literature has fallen short in capturing the nature and essence of this relationship. Two concepts are complementing each other and can strengthen each other due to their positive relation in the contemporary image of the firm as an institution (Mahmood, Z., Riaz, Z., 2008). As Bhimani and Soonawalla (2005) put it, CSR and CG are two sides of the same coin where it is implied in this model that the guidelines, reporting standards and monitoring devices of CG and CSR are co-dependent and should be developed jointly.If company has a well formed CG program in place, that would probably take care of most CSR issues and other way around.CSR and CG are therefore complementary in their shaping of the objective function and the constraints faced by corporations. They can reinforce each other in the modern vision of the firm as an institution that does not disregard various relevant constituencies in its search for increases in value (Beltratti, A., 2005).

CONCLUSION

Companies are still driven by competitive pressure on highly turbulent or some would even say chaotic markets. Offend or ignore any significant stakeholder group for too long and you put the health of the corporation at risk. The traditional concept of an organisation being led by single authority, is nowadays obscure and a very incomplete appreciation of what true leadership must be and how to put sustainable system behind success. In the modern age good leaders are an enabling force, helping people and organizations to grow and develop, which implies that a sophisticated alignment be achieved - of people's needs, and the aims of the organization. Accordingly responsible ways of doing business are becoming necessity. CG is not entirely effective without a sustainable CSR drive because a company has to respond to the needs of its various stakeholders in order to be profitable and create value for its shareholders/owners (Jamali, D., Safieddine, A. M., Rabbath, M., 2008).Therefore, CSR is becoming more and more important as a model that lies right at the intersection of competitive advantage and sustainable development, combining economic, ethical, social and ecological expectations of the business context. CSR is also more and more perceived as a preferred form of business paradigm that is formulated through concrete strategies in the development of business systems while at the same time it is seen in direct contribution of stakeholders to improve the quality of life, social issues and sustainable economic development. On the other hand, empirical studies have shown a correlation between the quality of corporate governance and company performance as measured by financial indicators, innovation rate, market share, placing new products on the market, satisfaction of customers, employees, etc. (Tschopp, H. G., 2005). They are expected to continue generating profits, while maintaining the highest standards of governance internally. The quality of corporate governance is, therefore, an important source of competitive advantage for modern companies. The aim is both to enhance positive impacts – for example through the innovation of new products and services that are beneficial to society and enterprises themselves – and to minimize and prevent negative impacts (European Commission, 2011). Although it is clear that this paper has its own set of limitations, it served the purpose of providing an introductory level exploration of the CSR-CG relationship and it will serve as a platform on which we'll explore those links in practice. Additionally, this relationship demands more theoretical and empirical investigation as this bond is still emerging.At the end companies are not just fighting for our minds but also for our hearts, for human cognition, emotion, motivation and will.If openness becomes a natural part of business proposition, then communicating it to all stakeholders becomes more natural.

References

1. Baller, J., de Bry, F. (2003). Corporate Social Responsibility and the Firm as a Person, Zagreb International Review of Economics & Business, 6:1-2, pp. 57-69
2. Beltratti, A. (2005). The Complementarity between Corporate Governance and Corporate Social Responsibility, The Geneva Papers, 30, pp. 373–386
3. Bhimani, A., Soonawalla, K. (2005). From conformance to performance: the corporate responsibilities continuum, Journal of Accounting and Public Policy, Vol.24, pp. 165-174
4. Black, L. D., Härtel, C. E. J. (2004). The Five Capabilities of Socially Responsible Companies, Journal of Public Affairs, 4:2, pp. 125-144
5. Carroll, A. B., Buchholtz, A. K. (2003). Business and Society: Ethics and Stakeholder Management. 5th ed. Thomson South-Western, Sydney
6. Conger, J. A., Lawler, E. E. III, Finegold D. L. (2001). Corporate Boards: New Strategies for Adding Value at the Top, Jossey-Bass, San Francisco
7. Committee on the Financial Aspects of Corporate Governance (1992) Reportwith Code of Best Practice, [Cadbury Report], London: Gee Publishing http://cg.org.cn/theory/zlyz/cadbury.pdf, (retrieved on January 25th, 2012)
8. Crane, A., McWilliams, A., Matten, D., Moon, J., Siegel, D. S. (2008). The Oxford Handbook of Corporate Social Responsibility, Oxford University Press, Oxford
9. Dahlsrud, A. (2006). How Corporate Social Responsibility is Defined: an Analysis of 37 Definitions, Corporate Social Responsibility and Environmental Management, 15, pp. 1-13
10. European Commission (2011).Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions - A renewed EU strategy 2011-14 for Corporate Social Responsibility, Office for Official Publications of the European Communities, Brussels, http://ec.europa.eu/enterprise/policies/sustainable-business/files/csr/new-csr/act_en.pdf (retrieved on February 15th, 2012)
11. European Commission (2011).Proposal for a Council Regulation on the Statute for a European private company, Commission of the European Communities, Brussels, http://ec.europa.eu/internal_market/company/docs/epc/proposal_en.pdf, (retrieved on February 15th, 2012)
12. European Commission (2001). Promoting a European framework for corporate social responsibility – Green Paper, Office for Official Publications of the European Communities, Brussels, http://eur-lex.europa.eu/LexUriServ/site/en/com/2001/com2001_0366en01.pdf (retrieved on February 15th, 2012)
13. Goodpaster, K. E., Matthews, J. B. Jr. (1982).Can a corporation have a conscience?,Harvard Business Review, January-February, pp. 132-141
14. Hart, S. (2005). Capitalism at the Crossroads – The Unlimited Business Opportunities in Solving the World's most Difficult Problems, Wharton School Publishing, Upper Saddle River (NJ)
15. Hawken, P. (1983). The Next Economy, Angus & Robertson Publishers, London
16. Hiles, A. (2007). The Definitive Handbook of Business Continuity Management, John Wiley and Sons, Chichester
17. Hollender, J., Breen, B. (2010). The Responsibility Revolution - How the Next Generation of Businesses Will Win, San Francisco: Jossey-Bass

18. Hopkins, M. (2003). The Planetary Bargain – Corporate Social Responsibility Matters, Earthscan, London
19. Jamali, D., Safieddine, A. M., Rabbath, M. (2008).Corporate Governance and Corporate Social Responsibility Synergies and Interrelationships, Corporate Governance, 16 (5), pp. 443-459
20. Kemper, A., Martin, R. L. (2011). After the fall: The global financial crisis as a test of corporate social responsibility theories, European Management Review No. 7, pp. 229–239
21. Kumar, S.,Tiwari, R. (2011).Corporate Social Responsibility: Insights into Contemporary Research, The IUP Journal of Corporate Governance, Vol. X, No. 1, pp. 22-44
22. Lacey, R., Kennett-Hensel, P. A. (2010). Longitudinal Effects of Corporate Social Responsibility on Customer Relationships, Journal of Business Ethics No. 97, pp. 581–597
23. Madelin, A. (2008). New EU Communication on Corporate Social Responsibility: a Missed Opportunity,Fidth, Amnesty International EU Office, Brussels, http://www.fidh.org/spip.php?article3196 (retrieved on February 05th, 2012)
24. Mahmood, Z., Riaz, Z. (2008). Using Case Study Research Method to Emergent Relations of Corporate Governance and Social Responsibility, Journal of Quality and Technology Management, 4 (1), pp. 9-20
25. McBarnet, D, Voiculescu, A., Campbell, T. (2007). The New Corporate Accountability: Corporate Social Responsibility and the Law, Cambridge University Press, Cambridge
26. McWilliams, A., Siegel, D. (2001). Corporate Social Responsibility: A Theory of the Firm Perspective, The Academy of Management Review, Vol. 26, No. 1, pp. 117-127
27. Mintzberg, H. (1999). Managing Quietly, Leader to Leader, No. 12, pp. 24-30
28. OECD Principles of Corporate Governance, 2004, http://www.oecd.org/dataoecd/32/18/31557724.pdf, (retrieved on February 10th, 2012)
29. Omazic, M. A. (2008), Corporate Social Responsibility and Corporate Governance in Tipuric, D. et al, Corporate Governance, Sinergija, Zagreb, pp. 323-361
30. Pearche II, J.A., Robins, R.B. (2011) Strategic Management.Formulation, Implementation and Control, 12th Edition, MCGraw-HillInternational Edition
31. Tipurić, D. (ed.) (2008).Korporativnoupravljanje, Sinergija, Zagreb
32. Tschopp, H.G. (2005) Corporate Governance – The Key to Success of Failure, Boardroom – Magazine for Corporative Governance, Leadership and Quality of Life, no.1.
33. Visser, W., Matten, D., Pohl, M., Tolhurst, N. (2007). The A to Z of Corporate Social responsibility: A Complete Reference Guide to Concepts, Codes and Organizations, John Wiley and Sons, Hoboken
34. Wilson, I. (2000). The new rules – ethics, social responsibility and strategy, Strategy and Leadership, Vol. 28, No 3, pp. 12-16(5)

Review
UDC 657.6

Patrick Velte
Carl-Christian Freidank

THE LINK BETWEEN IN- AND EXTERNAL ROTATION OF THE AUDITOR AND THE QUALITY OF FINANCIAL ACCOUNTING AND AUDIT

Abstract

The European Commission (EC) discusses in her green paper the external mandatory auditor rotation (audit firm rotation) as a reform measure to increase auditor independence, which could complement the internal mandatory rotation (auditor rotation) by the 8th EC directive. The present paper gives a state of the art analysis of the empirical research results with regard to auditor- and audit firm rotation. In contrast to the perception of the EC, the majority of the empirical results don't lead to an increased financial accounting- and audit quality by an audit firm rotation. Furthermore, the positive effects of the internal rotation period of seven years and the cooling off period of two years by the 8th EC directive are not empirically proved yet.

INTRODUCTION

Facing the capital markets' shrinking trust in the decision usefulness of financial accounting and auditing as a result of the financial crisis, the European Commission (EC) in their Green Paper (EC 2010) is in quest of ways to reform the professional standards of accountants and auditors. The intention of the EC is to increase audit quality by reducing the expectation gap, to increase auditor independence and preventing further audit market concentration. In order to increase auditor independence, based on actual autonomy (independence in fact) as well as on autonomy perceived as such by the capital markets (independence in appearance), the EC is considering introducing mandatory external rotation (audit firm rotation). While internal rotation (auditor rotation) stipulates changes within the audit firm, external rotation replaces the audit firm entirely, following a fresh start approach. Currently Italy is the only state in the EU with audit firm rotation rules (since 1974), which, however, was not able to prevent the financial fraud scandal at Parmalat. Austria introduced external rotation for financial years beginning on January 1, 2004, but repealed it before it came into effect. Similarly, compulsory audit firm rotation no longer exists in Greece and Spain.

The EC's considerations were already outlined in a draft directive dated February 17, 2004, regarding an amendment to the 8th EC directive (EC 2004) which was giving the option to choose between internal rotation after five years and external rotation after seven years. Upon passage of the modified 8th EC directive, audit firm rotation was not codified due to – according to the EC's assessment then – negative effects on audit quality were expected. For auditing bodies of public interest, compulsory internal rotation was introduced as a substitute aiming to enhance auditor independence. Based on the 8th EC directive, all responsible partners of auditing companies have since been obligated to submit to an internal rotation no later than after seven years. After a cooling off period of two years, the auditor in charge may reapprove their services with a given client.

At the same time, the US capital market was considering introducing compulsory external rotation in compliance to the Sarbanes Oxley Act (2002). Consistent with the EC's opinion of that time, however, the results of an empirical survey by the General Accounting Office (GAO 2003), objected to compulsory external rotation. As a substitute, an internal rotation cycle of five years as well as a cooling off period of two years according to Section 203 of the Sarbanes Oxley Act was introduced for all auditors who are primarily responsible for the mandate at hand or in charge of an internal revision of audits, and provided audits for clients in question. For all non responsible auditors in charge of crucial cases who are in regular contact with the company's administration, an extended rotation period of seven years, followed by a cooling off period of only one year is to be observed.

In light of the recent explosiveness caused by the EC green paper as well as various forms of rotation from an international point of view, this article mainly deals with the results of empirical audit research regarding effects of auditor- and audit firm rotation on financial accounting- and audit quality. With the green paper lacking a theoretical basis of the subject as well as an inventory of empirical research on auditor change, the EC's assumption of a positive link between rotation and quality of financial accounting and auditing is to be subject to further scrutiny.

ADVANTAGES OF MANDATORY ROTATION

Internal and external rotation is often considered a way to enhance audit quality due to prevention of the auditor's depending relationship with the management, distinguishing between the auditing of capital market oriented and non-capital market oriented corporations. Since traditional agency conflicts are characteristic in large management operated corporations, the necessity of a statutory rotation is solely related to this group of companies. Shareholders in small and medium-size companies are to exert greater influence on the management than an average private shareholder in a public company. This dichotomy in auditing standards has recently been contemplated by the EC in their green paper.

Burton/Roberts (1967) present a fundamental approach to the economic impact of auditor changes. Although, considering the assistant role of an auditor in a stock corporation, a long-term contract between supervisory board and auditor seems sensible, the independence in appearance might be limited due to a special trust relationship between management and auditor in a long-term assignment. Burton/Roberts (1967) suggest that personal relationships between auditor and management, the combination of auditing and consulting, as well as the auditor's goal of maintaining the assignment are determining factors towards reducing audit quality.

According to DeAngelo (1981a), quasi-rents according to low balling – without compulsory rotation – might present a financial incentive to the auditor to give up his independence, if the probability of exposure by the capital market is considered to be low. According to supporters of this theory, an auditor's low balling strategy which might be related to his lack of independence can be counteracted by compulsory rotation. Chi/Yu/Chiu (2004) do not agree with this opinion but state an adverse effect on independence in fact due to rotation under the existence of quasi rents and assignment by the owners. They point out that the auditor would give up his independence in the last audit period before the rotation because he assumes hidden transfers of the management since he no longer has to be concerned about the loss of quasi rents due to shareholders not being re-elected. According to Bigus/Zimmermann (2007), the absolute (client related), but not necessarily the relative quasi rents are cut short due to rotation, which implies that rotation does not necessarily cause an increase of auditor independence.

Irreconcilable differences of opinion between management and auditor are not risky to the auditor if a change is scheduled for the near future anyway, which is mentioned as another possible advantage. Literature assumes stricter and more relentless auditing under compulsory rotation, considering that the auditor wishes to diminish the risk of having his successor complain about his low performing upon review of previous years' audits. Finally the avoidance of organizational blindness under compulsory rotation is pointed out, as negatively influencing the audit efficiency, even under observation of independence. Hence, the auditor simply trusts his results from previous years instead of anticipating important changes in the company development and adjusting his auditing strategy.

RISKS OF MANDATORY ROTATION

The positive effects of compulsory rotation on the limitation and avoidance of low balling as mentioned in literature are not secured, since compulsory rotation creates system immanent disadvantages. Thus, a change of auditor incurs a higher monetary value of auditing costs and increased audit fees which result in additional costs of the initial audit and transaction costs on the part of the client. Especially long-term audit scheduling and following up on complaints or auditors' suggestions from previous audit periods would have to suffer under rotation. Empirical surveys in the US show that the auditor's risk of liability is significantly higher in first or second audits than in following audits (AICPA 1992). Since first audits tend to be of lower quality, negative responses of the capital market are to be expected upon a forced change of auditor. This way an investor can no longer distinguish a voluntary change of auditor due to opinion shopping of the management from a compulsory rotation, which increases his cost of information (Bigus/Zimmermann 2007). Therefore, for corporations which aim to offer high audit quality to the capital market, compulsory rotation in short intervals may be unfavourable. Even a statutory long-term rotation cycle (e.g. more than nine years) cannot prevent the risk of hidden intention of management.

Audit market concentration is another important disadvantage of compulsory rotation, which the EC critically reviews in its green paper. The european audit market for listed companies is dominated by the Big Four audit firms. The reason for this concentration lies in the Big Four companies having the highest experience value in auditing capital market oriented enterprises, according to De Angelo (1981b) they are related to a higher quality and independence, and have an extensive potential of resources in additional performances such as advisory services to show. This development of oligopoly in the global audit market makes an entry into the market very difficult for small and medium-size audit firms. In general, these difficulties cannot be overcome by compulsory rotation, since changes are made within the audit firm (internal rotation) or between Big Four audit companies (external rotation). Furthermore, practical experience suggests frequent changes from small to larger audit companies. In general view, the above mentioned impacts under rotation by a change of the audit company as opposed to a change of auditor within the company are stronger. The overall impact of compulsory rotation is, from a theoretical point of view, not explicit, therefore, even with the auditor applying low balling, a rotation does not necessarily imply higher quality but the interruption or shortfall of learning and experience effects can have an altogether negative effect on the quality of financial accounting and audit.

EMPIRICAL RESULTS OF AUDIT RESEARCH

EFFECTS OF AUDITOR ROTATION ON THE QUALITY OF FINANCIAL ACCOUNTING AND AUDIT

Empirical auditor change research has become highly significant particularly in jurisdictions of the US, Asia, and Australia. In order to determine the quality of financial accounting and auditing, a number of variables are used, which if viewed separately, provide an assessment of limited informational value (Bedard et al. (2008). In general, the dimension of accounting policy is operated by means of discretionary determination of time frames, according to paradigms outlined by Jones (1991) and DeFond/Park (2001). Outside investors tend to disapprove of an accounting policy with maximum results, especially regarding companies in a situation of losses (Jones 1991), the reason being that asymmetric flow of information between management and investors are encouraged in order to deliberately conceal the actual economic situation, or, for reasons of image policy, to portray it as being better than it is. Under a thorough and independent examination, the auditor will scrutinize a positive image policy more critically and will not tolerate questionable aspects of accounting. Since, as mentioned above, the risk of collaboration between management and auditor increases with the duration of the assignment, the following surveys will establish to what extent a possible enhancement of auditor independence through rotation might reduce accounting policy and create a more "conservative" application of accounting standards. In this context, Chi et al. (2009) create a positive link between introduction of compulsory internal rotation in Taiwan in 2004 and quality of financial accounting. Likewise for the Australian capital market Hamilton et al. (2005) prove in 3,621 cases, observed during the business years of 1998 – 2003, that internal auditor rotation reduces accounting policy. According to Gates/Lowe/Reckers (2007) an experiment among US students shows that auditor rotation increases investors' confidence in the quality of financial accounting in a regulatory environment with increased corporate governance procedures. As one among few surveys, Zimmermann (2008) refers to the German capital market. Based on 102 prime standard companies, an increase of audit fees (fee cutting) following an extended assignment was obvious. A significant relation between the duration of assignment and the level of accounting policy, however, could not be proven.

Besides the quality of financial accounting, the quality of auditing is determined by diverging variables, e.g. based on restricted going concern opinions, assuming that an independent auditor, facing companies with substantial liquidity issues, decides to restrict or deny the going concern opinion. With rotation, an increased rate of restricted or denied approval is expected, since the management wishes an unrestricted attestation and imposes pressure upon the auditor to have him comply. Using the above mentioned variable, Carey/Simnett (2006) prove that, in the case of 1,021 Australian enterprises during the business year of 1995, the audit quality decreases with increasing duration of the assignment and increases with internal rotation. However there is no proven correlation between the length of an assignment and the degree of accounting policy as a second variable. Dao/Mishra/Raghunandan (2008), who surveyed 635 US corporations in the business year of 2006 conclude that, in long-term assignments, investors realize a decrease of audit quality in a given time frame, which is reversed by internal rotation. However a fixed schedule of the rotation and cooling off period with an existing compulsory internal rotation as outlined in the 8th EC directive, which allows for another assignment of an auditor after the change, has not been sufficiently researched.

Watrin/Lindscheid/Pott (2008) research the impacts of changing the chief auditor and the authorizing auditor on the extent of accounting policy in the DAX, MDAX, SDAX, and TecDAX in the business years of 2004 – 2007. While there is no evidence of significant changes in accounting policy upon change of chief auditor, there are signs of an increase of earnings-improving accounting policy after a change of the authorizing auditor. This result is contrary to the efficiency of rotation, since it implies that the management assumes a lower quality of the initial auditing and expects a questionable accounting policy to be tolerated by the auditor. According to Cameran/Prencipe/Trombetta (2008), in the Italian capital market no positive impact can be detected in 1,439 surveys during business years between 1985 and 2004 regarding the extent of accounting policy under internal rotation. Blouin/Grein/Rountree (2007) draw an identical conclusion based on 407 US corporations in the business years of 2001 and 2002.

In addition to the above mentioned variables, the auditor independence is determined by the audit fees paid, which, in the US as well as the EU, requires the audited corporation to report in the notes and, in case of capital market oriented companies, disclosure of the audit firm in the transparency report. In this context there seems to be an increasing relation between non-audit and audit fees along with a decreasing independence in appearance, as quasi-rents per client according to low balling increase with higher additional income, and the auditor can be restricted in his ability to judge in order to keep his assignment. Based on 4,720 US corporations during the business years of 2000 and 2001, Gul/Jaggi/Krishnan (2007) point out that the auditor independence is rather hindered by non-audit fees and a short duration of assignment than by an extended cooperation, and that compulsory internal rotation is counterproductive.

Finally, the survey by Azizkhani/Monroe/Shailer (2007) examines the impact of rotation on the capital market's responses. The management board strives to increase the company value by decreasing the risk margin on allocated capital contribution. Reduction of capital contribution depends on the investors' confidence in audited financial accounting, and whether decision relevant information is presented. According to Azizkhani/Monroe/Shailer (2007), in 2,033 Australian corporations during business years of 1995 – 2005 no impact of internal rotation with Big Four audit companies on the costs of capital has been evident.

IMPACTS OF AUDIT FIRM ROTATION ON THE QUALITY OF FINANCIAL ACCOUNTING AND AUDIT

The following empirical surveys on external rotation mainly relate to the US capital market. The majority of empirical assessments disapprove of audit firm rotation, since there are either no effects or even negative effects on the quality of accounting and auditing detectable. Only Dopuch/King/Schwartz (2001), Davis/Soo/Trompeter (2008) and Boone/Khurana/Raman (2008) point out positive effects. Dopuch/King/Schwartz (2001) prove based on an experimental study in the US, that in case of audit without external rotation it is more likely that the auditor over time biases approval testates accommodating the management, and conceals errors from the public. In the experiment at hand, however, experience effects of the auditor under a long-term assignment remain uncovered. Davis/Soo/Trompeter (2009) prove based on 12,892 US corporations in the business years of 1991 – 1998 that the management takes advantage of its leeway in decisions and arrangements in short (two to three years) and very long duration of assignment (at least thirteen years) in order to fulfil or outdo result prognoses. The latter is considered positive by the capital market and may reflect in a higher demand of shares. The authors prove that the duration of the audit assignment has a positive effect on the extent of maximum earnings management, so that the audit quality is increased by external rotation after a longer duration. Boone/Khurana/Raman (2008) point out signs of interdependence between external auditor rotation and risk margin on allocated capital contribution in 12,493 surveys on the US capital market during the business years of 1974 – 2001. Capital costs decrease in the first years of the assignment and rise with its duration.

As outlined above, the majority of recent studies either does not show proof or documents a tendency of weakening the quality of accounting and auditing due to external rotation. Johnson/Khurana/Reynolds (2002) saw comparatively short assignments (two to three years) causing higher training costs combined with a lower quality of accounting in 11,148 US surveys during the business years of 1986 – 1995, while they did not find proof of lower quality in long-term assignments (at least nine years). Myers/Myers/Omer (2003) who surveyed 42,302 US corporations between 1988 and 2000 report that auditors in long-term assignments (more than five years) disapprove of a maximum accounting policy due to learning and experience effects. Likewise, Al-Thuneibat/Al Issa/Baker (2011) state a negative correlation between external rotation and the quality of accounting in 358 Jordan companies listed at the stock exchange between 2002 and 2006. In their survey of 35,826 or, respectively, 38,794 US corporations between 1990 and 2000, Ghosh/Moon (2005) show that investors, rating agencies and analysts assume positive interdependence between the duration of assignment and the quality of accounting, represented by the interest rate investors require, rating results, as well as the analysts' performance prognoses. Contrary to their results with US students on internal rotation, Gates/Lowe/Reckers (2007) show that investors' confidence in the financial accounting quality in a regulatory environment with increased Corporate Governance methods cannot be influenced by external auditor rotation. Furthermore, according to Carcello/Nagy (2004) based on the business years of 1990 – 2001, 267 US corporations showed balance manipulations mostly in the first three years of the assignment, since the management assumes lower quality of audit provided by new auditors. A long-term assignment (at least nine years), however, does not imply a significant increase of balance manipulations.

Mansi/Maxwell/Miller (2004), based on 8,529 US surveys between 1974 and 1998, question the usefulness of audit firm rotation and state negative capital market responses in the assessment of market-noted stocks of risk intensive companies. Therefore, with greater entrepreneurial risk, investors tend to rate the auditor's learning and experience effects in a long-term audit assignment higher than possible limitations of his independence. Likewise, Knechel/Vanstraelen (2007) show based on 618 Belgian companies for the business years of 1992 – 1996 that independence in appearance of the capital market does not decrease with extended assignments. Azizkhani/Monroe/Shailer (2007) see the duration of assignment in 2,033 Australian companies between 1995 and 2005 which are audited by Non-Big-Four audit firms in an inverse relation to the size of capital costs, whereas there are no significant changes under external rotation. Fargher/Lee/Mande (2008) are among the few surveys which compare the impact of internal and external rotation on 590 Australian companies during the business years of 1990 – 2004. They prove that in the first years after a change of auditor the management lowers the extent of accounting policy if internal rotation has taken place. Under external rotation, however, a significant increase of discretionary periodical classification is established.

In relation to the quality of auditing, Geiger/Raghunandan (2002) survey 117 US Corporations with significant liquidity issues between 1996 and 1998 and observe the probability of restrictions in going concern opinions to be lower in the first years of the assignment based on a higher reporting error rate of the auditor, based on sanctions by the Stock Exchange Commission (SEC). Jackson/Moldrich/Roebuck (2008) point out, based on 1,750 companies in the Australian capital market between 1995 and 2003 that the probability of restricted going concern opinions increases with the duration of assignments due to the auditor's experience. According to Jackson/Moldrich/Roebuck (2008), interdependence between the duration of assignment and the quality of financial accounting cannot be established as the second variable, so that the necessity of compulsory external rotation is ultimately dismissed. In the case of the Spanish audit market, based on 1,326 companies with significant liquidity issues in the business years of 1991 – 2000, Ruiz-Barbadillo/Gomez-Aguilar/Carrera (2009) are not able to prove empirically that an external auditor change increases the probability of restricted going concern opinions.

CONCLUSION

Auditor independence is an indispensable requirement in providing appropriate quality of financial accounting and auditing. Not only independence in fact but also independence in appearance, the auditor independence perceived by the capital market, is of utmost importance in this context. In order to strengthen independence, the application of internal and external auditor rotation is discussed. While in the revised version of the 8th EC directive internal rotation has been mandatory, the present green paper raises questions on the necessity of a compulsory external rotation (again), which stipulates the change of the audit firm. Since the EC provides neither a theoretically nor an empirically founded economic justification for the reforms in question, the effect of rotation on the quality of financial accounting and auditing is uncertain. Due to this, the purpose of this analysis is to consult recent results of empirical audit research from an international point of view and critically challenge the EC's plans. An overview shows that an enhancement of auditor independence will not necessarily be achieved by implementing rotation. It might be paid for by an interruption or lack of learning and experience. Empirical studies do not show an increased quality of financial accounting and audit under external change of auditors. In the area of internal rotation, however, there are just as little empirical findings. Therefore, the extent to which the rotation period of seven years and the cooling off period of two years as mentioned in the 8th EC directive in the context of internal rotation effects an increased quality of accounting and auditing cannot be determined.

Regarding the empirical surveys mentioned above, it has to be pointed out that the focus of empirical auditor change research is mainly on US, Asian, and Australian capital markets, while only a few surveys exist on EU member states such as Italy, Germany, Belgium, and Spain. Furthermore, the variables used to estimate quality of financial accounting and audit, such as discretionary accruals or restriction of going concern opinions, are of limited conclusional value. Based on these facts there is need for action on the part of the EC to perform cross-national empirical studies before implementing compulsory external rotation throughout the EU. The proposal of a multi-periodical assignment of auditors as a legitimate temporary auditing monopoly as mentioned in literature, such as in Belgium, France, Italy or Spain, is to be taken into consideration.

References

1. AICPA (1992). Statement of Position Regarding Mandatory Rotation of Audit firms of Publicly Held Companies, New York.
2. Al-Thuneibat, A. A., Al Issa, R. T. I. and Baker, R. A. A. (2011). Do audit tenure and firm size contribute to audit quality. Managerial Auditing Journal, 26, 317-334.
3. Azizkhani, M., Monroe, G. S. and Shailer, G. (2007). Auditor Tenure and Perceived Credibility of Financial Reporting, Working Paper, Canberra.
4. Bedard, J. C. et al. (2008). Risk Monitoring and Control in Audit Firms. Auditing, 27, 187-218.
5. Bigus, J. and Zimmermann, R.-C. (2007) Unabhängigkeit und Regulierung von Abschlussprüfern. German Working Papers in Law and Economics, Osnabrück.
6. Blouin, J., Grein, B. M. and Rountree, B. R. (2007). An Analysis of forced auditor change. The Accounting Review, 82, 621-650.
7. Boone, J. P., Khurana, I. K. and Raman, K. K. (2008). Audit firm tenure and the equity risk premium. Journal of Accounting, Auditing & Finance, 23, 115-140.
8. Burton, J. C. and Roberts, W. (1967). A Study of auditor changes. Journal of Accountancy, 123, 31-36.
9. Cameran, M., Di Vincenzo, D. and Merlotti, E. (2005). The audit firm rotation rule. Working Paper. Bocconi.
10. Cameran, M., Prencipe, A. and Trombetta, M. (2008). Earnings management, audit tenure and auditor changes. Working Paper, Madrid.
11. Carcello, J. V. and Nagy, A. L. (2004). Audit firm tenure and fraudulent financial reporting. Auditing, 23, 55-69.
12. Carey, P. and Simnett, R. (2006). Audit Partner Tenure and Audit Quality. The Accounting Review, 81, 653-676.
13. Chi, W., Yu, H. and Chiu, S. (2004). Mandatory rotation and auditor independence. Taiwan Accounting Review, 5, 71-104.
14. Chi, W. et al. (2009). Mandatory audit-partner rotation, audit quality, and market perception. Contemporary Accounting Research, 26, 359-391.
15. Dao, M., Mishra, S. and Raghunandan, K. (2008). Auditor Tenure and Shareholder Ratification of the Auditor. Accounting Horizons, 22, 297-314.
16. Davis, L. R., Soo, B. and Trompeter, G. (2009). Auditor Tenure and the ability to meet or beat earnings forecasts. Contemporary Accounting Research, 26, 517-548.
17. DeAngelo, L. E. (1981a). Auditor Independence, „Low Balling“ and Disclosure Regulation. Journal of Accounting and Economics, 3, 113-127.
18. DeAngelo, L. E. (1981b). Size and Audit quality. Journal of Accounting and Economics, 3, 183-199.
19. DeFond, M. and Park, C. (2001). The reversal of abnormal accruals and the market valuation of earnings surprises. The Accounting Review, 76, 375-404.
20. Dopuch, N., King, R. R. and Schwartz, R. (2001). An experimental investigation of retention and rotation requirements. Journal of Accounting Research, 39, 93-117.

21. EC (2004) Vorschlag für eine Richtlinie über die Prüfung des Jahresabschlusses und des konsolidierten Abschlusses und zur Änderung der Richtlinien 78/660/EWG und 83/349/EWG des Rates vom 17.02.2004, http:/www.europa.eu.int/comm/internal_market/ auditing.htm.

22. EC (2006) Richtlinie 2006/43/EG des Europäischen Parlaments und des Rates vom 17.05.2006 über Abschlussprüfungen von Jahresabschlüssen und konsolidierten Abschlüssen, zur Änderung der Richtlinien 78/660/EWG und 83/349/EWG des Rates und zur Aufhebung der Richtlinie 84/253/EWG des Rates. Amtsblatt der Europäischen Union L 157/83 vom 16.08.2006, 87-107.

23. EC (2010a) Grünbuch: Weiteres Vorgehen im Bereich der Abschlussprüfung: Lehren aus der Krise [KOM (2010) 561 endgültig], http://ec.europa.eu/internal_market/consultations/docs/2010/audit/green_paper_audit_de.pdf.

24. EC (2010b) Grünbuch: Corporate Governance in Finanzinstituten und Vergütungspolitik [KOM (2010) 285 endgültig], http://ec.europa.eu/internal_market/company/docs/modern/com 2010_284_de.pdf.

25. Fargher, N., Lee, H.-Y. and Mande, V. (2008).The effect of audit partner tenure on client managers' accounting discretion. Managerial Auditing Journal, 23, 161-186.

26. Gates, S. K., Lowe, D. J. and Reckers, P. M. (2007). Restoring public confidence in capital markets through auditor rotation. Managerial Auditing Journal, 22, 5-17.

27. Geiger, M. A. and Raghunandan, K. (2002). Auditor Tenure and Audit Reporting Failures. Auditing, 21, 67-78.

28. GAO (2003). Report on the Senate Committee on Banking. Housing and Urban Affairs and the House Committee on Financial Service. Public Accounting Firms. Required Study on the Potential Effects of Mandatory Audit Firm Rotation. GAO-04-216. New York.

29. Ghosh, A. and Moon, D. (2005). Auditor Tenure and Perceptions of Audit Quality. The Accounting Review, 80, 585-612.

30. Gramling, A. A., Jenkins, J. G. and Taylor, M. H. (2010). Policy and research implications of evolving independence rules for public company auditors. Accounting Horizons, 24, 547-566.

31. Gregory, A. and Collier, P. (1996). Audit fees and auditor change. Journal of Business Finance & Accounting, 2, 13-28.

32. Gul, F. A., Jaggi, B. L. and Krishnan, G. V. (2007). Auditor Independence. Auditing, 26, 117-142.

33. Hamilton, J. et al. (2005). Audit Partner Rotation, Earnings Quality and Earnings Conservatism. Working Paper. Sydney.

34. Jackson, A. B., Moldrich, M. and Roebuck, P. (2008). Mandatory audit firm rotation and audit quality. Managerial Auditing Journal, 23, 420-437.

35. Johnson, V. E., Khurana, I. K. and Reynolds, J. K. (2002). Audit firm tenure and the quality of financial reports. Contemporary Accounting Research, 19, 637-660.

36. Jones, J. (1991). Earnings management during import relief investigations. Journal of Accounting Research, 29, 193-228.

37. Knechel, W. R. and Vanstraelen, A. (2007). The relationship between auditor tenure and audit quality implied by going concern opinions. Auditing, 26, 113-131.

38. Mansi, S. A., Maxwell, W. F. and Miller, D. P. (2004). Does auditor quality and tenure matter to investors? Journal of Accounting Research, 42, 755-793.

39. Myers, J. N., Myers, L. A. and Omer, T. C. (2003). Exploring the term of the auditor-client relationship and the quality of earnings. The Accounting Review, 78, 779-799.

40. O'Keefe, T. B., King, R. D. and Gaver, K. M. (1994). Audit fees, industry specialization and compliance with GAAS reporting standards. Auditing, 13, 41-55.

41. One Hundred Seventh Congress of the United States of America (2002). Sarbanes-Oxley Act (H.R. 3763), Washington D.C. http://news.findlaw.com/hdocs/gwbush/sarbanesoxley 072302.pdf.

42. Pott, C., Mock, T. J. and Watrin, C. (2009). Review of empirical research on rotation and non-audit services. Journal für Betriebswirtschaft, 58, 209-239.

43. Ridyard, D. and DeBolle, J. (1992). Competition and the regulation of auditor independence in the EC. Journal of Financial Regulation and Compliance, 1, 163-169.

44. Roberts, R. W. and Glezen, G. W. (1990). Determinants of School District Audit Fees. Research in Governmental and Nonprofit Accounting, 6, 220-228.

45. Ruiz-Barbadillo, E., Gomez-Aguilar, N. and Carrera, N. (2009). Does mandatory audit firm rotation enhance auditor independence? Auditing, 28, 113-135.

46. Simunic, D. A. (1980). The pricing of audit services. Journal of Accounting Research, 22, 161-190.

47. Watrin, C., Lindscheid, F. and Pott, C. (2008). The effect of audit engagement and review partner rotation on audit quality. Working Paper, Münster.

48. Zimmermann, R.-C. (2008). Abschlussprüfer und Bilanzpolitik der Mandanten. Gabler. Wiesbaden.

Preliminary Report
UDC 331.224-057.17:005.7>(497.5)

Ivana Načinović

AN EXPLORATION OF EXECUTIVE COMPENSATION IN CROATIA - WHAT ARE ITS IMPLICATIONS WITHIN CORPORATE GOVERNANCE?

Abstract

Highly limited knowledge on executive pay in (post)transition economies creates demand for research in this filed; this paper explores executive compensation structure in Croatia. The research was conducted among Croatian public limited companies during December 2010 through February 2011at a response rate of 18,44%. The structure of the compensation package in Croatia was revealed: it is consistent with compensation packages in other (post)transition countries that adopted continental system of corporate governance. A total of 76% of examined Croatian firms have implemented incentive compensation that is the basis for exploiting executive compensation as a mechanism within corporate governance.

INTRODUCTION

Executive compensation encompasses compensation for the set of employees who, by theory, have crucial impact on the definition and implementation of an organization's strategy and overall firm business. Compensation paid to top executives is among top topics with popular press, with critics claiming that amounts paid to executives are too high. However, the *issue* of executive compensation has diverse scope in different countries; although abundant executive compensation academic literature covers numerous theoretical and practical issues within top management compensation, most of these contributions are being based on data from Anglo-Saxon countries, mainly classified within Anglo-American system of corporate governance. Majority of these countries implemented full transparency in compensation through legislation that prescribes revealing the data on executive compensation to potential investors and the general public. At the same time very little is known about executive compensation within continental system of corporate governance, especially among European (post)transition economies.

The executive compensation package can, and most often does, contain many components. These components have different effects on employee motivation and risk, as well as various costs for the corporation. The most common components of compensation are salary, bonus, stock options and stock grants, pensions, benefits and perks (Balsam, 2001). A well-designed compensation plan must make tradeoffs between the components to maximize the net benefit to both the corporation and the executive. Such compensation package can motivate executives to use corporate resources to increase shareholder value, thus rewarding simultaneously executives and shareholders. Furthermore, executive compensation is important because it affects compensation levels and composition throughout the organization. Designing an optimal executive compensation plan for the set of circumstances has overall effects and consequences for various aspects of an organization's functioning and needs to be taken special care of. In case compensation is too low relative to executive's best alternative opportunity, he or she could leave creating additional costs for the corporation.

Executive compensation theory is mostly founded within agency theory framework. The separation of ownership and control in contemporary publicly traded organizations creates a situation where managers rule and coordinate all firm activities, however except for their possible job loss and lost pay, do not bear any financial loss in case of firm's malperformance. This problem of managerial power and discretion, also known as the agency problem, creates prerequisites for potentially conflict interests of top managers and owners (Jensen & Meckling, 1976, Fama & Jensen, 1983, Mehran, 1992) in case top managers engage in self-serving behaviours and make decisions suboptimal from owners' point of view.

Academics refer to executive compensation as a mechanism of corporate governance. The solution to the separation of ownership and management functions, or the agency problem, is to determine executive pay based on the shareholder's wealth. Implementing incentive compensation in the form of variable pay for performance minimizes the agency problem trough linking executive pay to shareholders wealth. Pay for performance paradigm is founded in the assumption that „*homo oeconomicus*" oriented executives might not always pursue with actions in shareholders' best interest. Thus in order to motivate executives to take actions in shareholders' interest their pay should be linked to changes in shareholder wealth.

Executive's compensation package is to be structured on different basis, regarding on its intended purpose. The focus of this research was to determine the structure executive compensation packages among public limited companies in Croatia in order to comment on the role of executive compensation within corporate governance. Considering the two tiers corporate governance system present among Croatian firms with formally separated executive directors and supervisory board, the focus of this paper includes compensation for executive directors only.

CEO COMPENSATION IN TRANSITION ECONOMIES

Publicly traded companies within transition economies often have a controlling shareholder or concentrated ownership structure. When ownership and management are arranged in this way, managers do not have as substantial power as in Anglo-American countries. This modifies the size of the agency problem and the role(s) to be given to executive compensation. Nevertheless, in these countries executive compensation is given status of classified data and lack of transparency in executive compensation limits available knowledge of executive compensation in transition economies.

Central and Eastern European economies have undergone transition process which has established new ownership structure featuring also a change in managers' profile. A key feature of new markets for executives in countries that for one or two generations practiced egalitarian compensation is the high level of compensation relative to other wage earners (Eriksson, 2005:660), often calculating pay of top managers as a low multiple of the average firm wage.

There is very little systematic evidence on senior executive compensation in transition countries. We are only aware of Jones & Kato (1996) study of CEO compensation in Bulgaria followed by later Jones & Klinedinst (2006) work, Eriksson (2005) study examining managerial pay and executive turnover in Czech Republic and Slovakia and Slapničar et. al. (2005) paper on social comparison as a determinant of senior executives' compensation in Slovenia.

Structuring executive compensation packages in transition economies does not necessarily follow theoretical expectations established within Anglo-American system of corporate governance where equity based compensation in the form of stock options has been considered a reason for a high growth in the overall amounts received by top executives (Jensen & Murphy, 2004). Beer & Katz (2003) find that the egalitarian social values of Europeans cause them to have negative views of executive incentive systems known in the USA. Considering the high proportion of variable compensation within Anglo-Saxon countries, differences to executive compensation in (post)transition economies are obvious.

Slapničat et al. (2005) within their paper reveal some facts on senior executive compensation in Slovenia. The institutionalized Criteria on Senior Executive Pay approved by several Slovenian associations and chambers defines fixed salary of CEOs as the sum of the average employee salary and average salary in the economy multiplied by 4 for large companies, by 3 for medium companies, and by 2 for small companies. The criteria suggest that on the top of fixed salary a maximum bonus of 25% is to be paid if a company performance exceeds the one of the industry measured as net earnings, ROE, increase of export and increase of retention of employment level. Authors argue that the average amount of senior executives' compensation bonus typically comprises around 10-15% of the total compensation according to earlier researches available, although in-depth interviews with senior executives revealed that variable part is practically non-existent. In about 25% of the sampled companies the second performance-contingent part of compensation is managerial profit sharing; subject to year-end negotiations between managers and Supervisory Boards, often with no predetermined relation between corporate performance and managerial share in profit. The study performed (based on 2003 questionnaire) revealed that firm performance does not influence executive pay but its power is contingent upon other characteristics of corporate governance such as ownership concentration and managerial entrenchment. On average, senior executive pay exceeds the employees' pay by 5,8 times.

Table 1: Description of senior executive compensation in transition economies

Slovenia	Bulgaria	Czech Republic	Slovakia
• Ratio senior executive pay to employee pay: 5,8 (Slapničar et. al., 2005) • Bonus to total compensation of senior executives: 15% (Slapničar et. al., 2005) • In about 25% of the sampled companies the second performance-contingent part of compensation is managerial profit sharing • Stronger ownership concentration does not bring to a stronger link between pay and performance (Slapničar et. al., 2005)	• During 1995 the annual CEO compensation was about 3,07 times the average workers wage (Jones&Kato, 1995) • The only performance variable which is found to influence changes in CEO pay is total assets (sensitivity of 0,00004) (Jones & Kato, 1996)	• CEOs earn 60-80% more than executives at the next level of the hierarchy in the firm (Eriksson, 2005) • Managers in Czech state-own firms obtain the same pay as in privately owned firms (Eriksson, 2005) • statistically significant and a positive relationship between the changes in pay and change is corporate performance measured in profit/sales (Eriksson, 2005)	• CEOs earn 30-40% more than executives at the next level of the hierarchy in the firm (Eriksson, 2005) • Ownership structure affects executive compensation (Eriksson, 2005)

Jones & Kato (1996) argue that in Bulgaria during 1995 the annual CEO compensation was about 3,07 times the average workers wage, as such being rather lower than what has been reported for western countries. Exploring pay for performance for Bulgarian CEO's revealed that the only performance variable which is found to influence changes in CEO pay is total assets. However, this pay for performance sensitivity appears to be rather modest, amounting to 0,004% change in CEO pay for every 1 growth in assets. The absence of pay-profitability relationships (profits, ROA or profit margin) according to Jones & Kato (1996) suggest that executive compensation is still largely structured so as to provide incentives for managers to increase size (or resist downsizing) and pay no attention to profitability.

Eriksson (2005) in his paper wrote about managerial pay in Czech Republic and Slovakia. In Czech Republic CEOs earn 60-80% more than the other executives at the next level of the hierarchy in the firm, whereas Slovak CEOs earn 30-40% more than the consecutive managerial level. Managers in Czech state-own firms obtain the same pay as in privately owned firms, with the impact of ownership being larger for Slovak managers. Czech managers have reasonably strong incentives to increase profitability of companies they are heading as there is a statistically significant and a positive relationship between the changes in pay and change is corporate performance measured in profit/sales.

There is an obvious lack of comparative analysis of executive compensation in transition economies due to lack of relevant data transparency and especially methodological consistency. Although prior mentioned studies are not based on the consistent dataset, given the general scarcity of studies on executive compensation in these countries they provide at initial information on the conception of executive compensation in this area.

METHODOLOGY OF RESEARCH

This paper explores executive compensation among public limited companies in Croatia. The actual study of executive compensation among public limited companies quoted on Zagreb Stock Exchange included triangulation approach. Preliminary phase of the research was performed through several interviews with public limited companies' CEOs, followed by a questionnaire survey. The preliminary phase revealed that Croatian CEOs' are not willing to reveal any information of the exact monetary value of compensation amounts received in different forms of compensation, even for academic purpose. They were willing to discuss compensation setting processes, the components of the compensation package, and their perceptions of the ideal compensation package, however, questions about the exact monetary value of specific compensation components were not answered.

A questionnaire survey was sent out to all public listed firms in Croatia. In the period from December 2010 through February 2011 a response rate of 18,44% was achieved. The aim of the survey was to detect the components of the compensation package for Croatian managers with relative proportions of different components in the package in 2009. Also, it included questions on executive compensation negotiations, influence of different parties in the executive compensation negotiation processes, changes in compensation etc. The nature of these data is inevitably executive perception.

Respondents to both qualitative and quantitative research were executive directors, meaning executive members of the board of directors. There were 78,95% male respondents and 21,05% women.

The average ownership concentration indicators are shown in the following table. The data show a highly concentrated ownership structure since the average ownership percentage of the largest shareholder averages to 55,23%. Average ownership concentration for top five owners according to ownership amount averages to almost 80%. State ownership is quite widespread among public limited companies in Croatia since the average amount of state ownership among sampled firms is 10,8%.

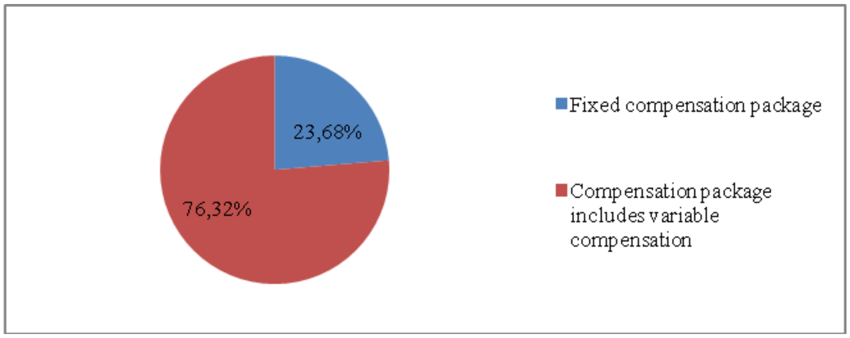
Table 2: Description of ownership structure for sampled firms

Ownership indicator	Mean
Ownership amount of top blockholder	**55,23%**
Ownership concentration (5 major owners)	**79,93%**
Ownership concentration (10 top owners)	**85,75%**
State owned	**10,80%**
Owned by institutional investors	**14,52%**
Owned by foreigners	**12,10%**

EXECUTIVE COMPENSATION IN CROATIA

The exploration of executive compensation packages among Croatian managers was based on the relative amount of compensation received by top managers. As seen from Figure 1, 23,68% of examined firms did not implement any form of variable or incentive compensation, providing only fixed compensation to their executives. Additional research has shown a strong ownership concentration among these firms: these firms have a single controlling shareholder, either the state or a known private owner. In the context of corporate governance, such compensation packages do not have as strong impact on executive motivation and behaviour as variable compensation, and the role(s) it can take within corporate governance are doubtful.

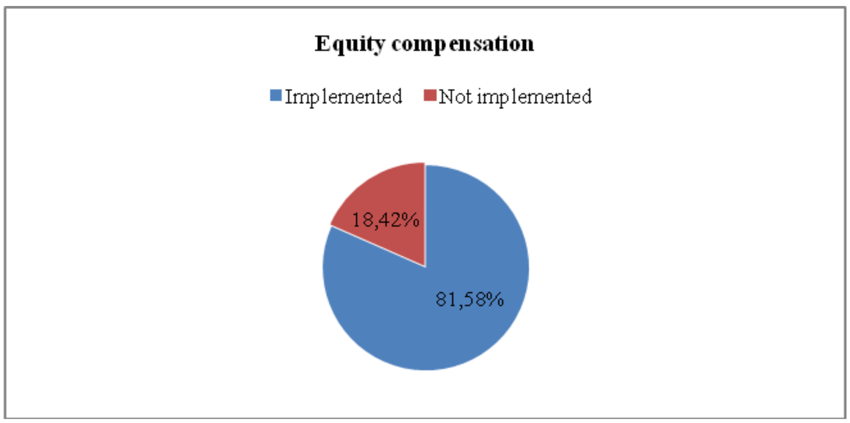
Figure 1. The use of variable compensation among Croatian firms



Equity compensation in the form of stocks, stock options and other forms of equity compensation (performance shares, restricted shares, phantom shares, SARs etc.) explicitly ties owners' and managers' interests and thus is generally known for forming the largest part of long term compensation. The use of equity based compensation had a massive increase in the past, this trend was created mostly in the USA where in the beginning of the 21st century almost 63% of total compensation package was paid in the form of equity compensation, a trend followed by European countries (Kaplan, 2006: 38).

The percentage of equity based compensation to the executive's total compensation package should not be so large as to cause the executive to focus only on the price of the company stocks while neglecting the operational performance. Our data show that at the time of the research, equity compensation was a marginal component of executive compensation for Croatian firms. Equity compensation as a component of the compensation package was used by only 18,42% of all examined firms. However, we must emphasize that the research was performed during the global economic crisis, which might have had an impact on these findings for Croatian managers.

Figure 2. The use of equity compensation among Croatian firms



With 76,32% of firms in Croatia that employ some form of variable compensation and 18,42% of firms that use equity based compensation in the following step we explored the exact structure of the compensation package for top executives.

Table 3. Descriptive statistics of executive compensation in Croatian firms

	% of total compensation in 2009			
	Fixed compensation (basic pay)	Variable compensation	Cash bonus	Equity based compensation
Average	82,92	17,08	13,34	3,47
Median	80,00	20,00	12,50	,00
Std. dev.	14,026	14,026	12,600	10,547
Variance	196,723	196,723	158,772	111,229
Minimum	43	0	0	0
Maximum	100	57	50	57

The survey revealed the structure of the overall compensation packages for Croatian top managers in 2009. The total compensation amount received by Croatian executive board members in 2009 included an average of 82,92% of fixed pay and 17,08% of variable pay.

Variable pay can be paid out in the form of cash bonus or equity based compensation. Cash bonus amounted on average to 13,34% of the total compensation package. At the same time equity based compensation in the form of stocks and stock options was more an exception than the core component of compensation packages. Equity based compensation on average amounted to only 3,47% of the total compensation package. Still, as can be seen from Table 3, overall variance in executive compensation was pretty high, as the maximum amount of equity based compensation was 57%.

Unlike USA, Continental Europe is generally known for its disinclination to excessive executive compensation. Mahoney (1979) suggested that the differential in compensation judged appropriate for adjacent hierarchical levels in the organization hierarchy is approximately 30-40%. He infers that corporate compensation practice reflects social perceptions of differences in rank and evolves to a structure of relationships consistent with social norms of rank differentials. The ratios vary somewhat from one industry to another. Horizontal and vertical pay disparity can have economic and behavioural effects (Henderson & Fredrickson, 2001). We still lack unified empirical evidence on the relationship among the size of the disparity and corporate performance, and whether it is low or high pay disparity that is related to better performance results.

Table 4. Executive to average firm pay

Pay ratio	Percent (%)	Cumulative percent (%)
2:1	18,4	18,4
4:1	31,6	50,0
6:1	21,1	71,1
8:1	18,4	89,5
10 or more:1	10,5	100,0
Total	**100,0**	

Analysis of CEO pay disparity in Croatia revealed that vertical pay dispersion in Croatia is comparable to other transition economies; however lower than among Anglo-American countries. In most cases (31,6%) the ratio of executive pay to average firm pay amounts to 4:1. The ratio of executive pay to average firm pay of 10 or more to 1 is found among only 10,5% of examined firms. Cumulative percentages show that half of sampled firms have executive pay that is up to 4 times greater than the average firm pay.

DISCUSSION

Agency model postulates that the separation of ownership and control functions creates circumstances for a potential conflict of interest among management and owners in case executives' decisions are suboptimal from shareholders' point of view. The same theory suggests that this conflict of interest can be reduced trough executive compensation system, management share ownership or by corporate control. Control over executive behaviour is dependent upon established system of corporate governance; prominent mechanisms of corporate governance can have different impact on executive and firm behaviour (Shleifer&Vishny, 1997). Core issue within corporate governance is the establishment of mechanisms that will assure executive behaviour in firm's best interest, with executive compensation being recognized as one of such mechanisms (Zajac & Westphal, 1994, Beatty & Zajac, 1994).

In the agency setting the extent of the potential conflict of interest among managers and owners is influenced by the firm ownership structure. Ownership concentration is one of the key distinguishing factors among Anglo-American and continental system of corporate governance. Corporate governance in the USA or UK is characterized by a highly fragmented ownership structure where the dispersed ownership structure in diminishes possibilities for monitoring from shareholders and increases executive power. On the other hand, corporations in Continental Europe are known for their ownership concentration.

Traditional view of corporate governance is based on the assumption of dispersed ownership, an attribute of the Anglo-American system of corporate governance. However, the foundations on which continental system of corporate governance developed, including South-Eastern European post-transition economies (Croatia included) do not share this feature (Lubatkin et al., 2005; Pederson & Thomsen, 1997). Continental systems of corporate governance with concentrated ownership have different set of fundamental problems and corporate governance features. The issue here is not how to discipline executives but how to protect minority shareholders (Enriques&Volpin, 2007).

The amount of research addressing the question of how executive compensation affects managerial decision making and firm outcomes is minimal in comparison with the large volume of work on pay-for performance relations (meta-analyses by Gomez-Mejia & Wiseman, 1997; Devers et. al., 2007). Thus it is unrewarding to comment on the components of the optimal compensation package. Optimal compensation package should be structured taking into account all potential determinants of executive compensation, such all those related with economic or governance conditions and the manager itself.

The structure of the executive compensation in Croatia, as found with this research, is consistent with executive compensation in other transition economies, especially Slovenia. However, these compensation packages vary greatly in comparison to the compensation packages in Anglo-American countries. The most important compensation component in Croatia is fixed compensation (82,9% of the total compensation package). The relative amount of fixed pay differs among countries, however it is still worldwide the core component of the compensation package and this information is not unusual. However, there are 23,68% of Croatian public limited firms that offer only this form of compensation that has a low incentive potential to motivate executives to take desirable actions.

Assigning a role to executive compensation within corporate governance would request for compensation components to modify executive behaviour in a manner so that they behave as owners themselves would do. Fixed compensation does not bring to this goal as from manager's point of view it is a risk-free form of compensation that is granted during certain period (Wiseman & Gomez-Mejia, 1998:140) and the only incentive related to basic pay is that losing management position would infer losing fixed pay as well (Van Herpen et al., 2005).

Unlike fixed compensation, variable compensation in the form of pay for performance is strongly related to corporate governance. Pay for performance reaches its full potential if used as internal monitoring mechanism. The need for monitoring is defined by the extent of potential conflict among managers and owners. Concentrated ownership structures, as have been shown for Croatia, modify the extent and size of the agency problem.

Examining relationship among pay and performance is mostly performed as confirmatory analysis, measuring compensation as a reward for prior performance, or as a means of ex post setting (Fama, 1980). Furthermore, most cases assume a linear relationship among executive compensation and firm performance. Very limited research covers the issue of consequences that executive compensation packages create to firm performance. For example, Hayes and Schaefer (2000) show that current CEO compensation can serve as an indication of future return to equity. Still we find the issue of relationship among executive pay (amounts and structure) and behaviours to be under researched compared to the importance of executive's actions. Pay for performance is implemented among Croatian firms, variable compensation on average amounts to 17,08% of the total compensation package. Considering the possibilities for monitoring from share block holders trough their representation in the supervisory boards this relative amount might satisfactory for corporate governance purposes.

CONCLUSIONS

The study contributes to the evidence of compensation practices in European (post)transition economies. We showed a concentrated ownership of Croatian firms, where we can expect owners of larger share parts to take the effort in firm governing and constrain managerial discretion. In such circumstances with stronger shareholder monitoring the need for executive compensation to take additional roles (besides direct remuneration for the effort and time employed) is lower than in Anglo-Saxon countries. Our data show that there are similarities in executive compensation in (post)transition economies which is consistent with the recognized relationship among executive compensation and corporate governance system.

Among public limited companies in Croatia, fixed compensation in the form of base pay is the most important compensation component. On average, it amounts to 82,9% of the total compensation package. Incentive compensation (on average 17,1% of the total compensation package) is paid out either as cash bonus or equity based compensation, with cash bonuses amounting to 13,3% of the total compensation package and equity based compensation 3,5% of the overall compensation package. We can expect that among 76% of examined Croatian firms with implemented incentive compensation executive compensation can take additional roles within corporate governance.

Shortcomings of this study are related to the lack of relevant data. The study included relative amounts of compensation package components, not the actual monetary values. Sample size is small compared to international standards and comparable studies although representative for the number of Croatian public limited companies listed in Zagreb Stock Exchange. Being aware of the current study limitations, it is necessary to continue to gather firm data and to further elaborate this issue.

References

1. Balsam, S. (2001) *An Introduction to Executive Compensation*. San Diego: Academic Press
2. Beatty, R. P. i Zajac, E. J. (1994) Top management incentives, monitoring, and risk sharing:A study of executive compensation, ownership and board structure in initial public offerings. *Administrative Science Quarterly*, 39, pp. 313-336.
3. Beer, M. i Katz, N. (2003) Do incentives work? The perceptions of a worldwide sample of senior executives. *Human Resource Planning,* 26 (3), pp. 30-44.
4. Devers, C. E., Cannella, A. A., Reilly, G. P., Yoder, M. E. (2007) Executive Compensation: A Multidisciplinary Review of Recent Developments. *Journal of Management*, 33 (6), pp. 1016-1072.
5. Enriques, L. i Volpin, P. (2007) Corporate Governance Reforms in Continental Europe. *Journal of Economic Perspectives*, 21 (1), pp. 117-140.
6. Eriksson, T. (2005) Managerial pay and executive turnover in the Czech and Slovac Republics. *Economics of Transition*, 13 (4), pp. 659-677.
7. Fama, E. F. (1980) Agency Problems and the Theory of the Firm. *The Journal of Political Economy*, 88 (2), pp. 288-307.
8. Fama, E. F., Jensen, M. C., (1983). Separation of ownership and control, Journal of Law and Economics, 26, pp. 301-325.
9. Gomez-Mejia, L., Wiseman, R. M. (1997) Reframing Executive Compensation: An Assessment and Outlook. *Journal of Management*, 23 (3), pp. 291-374.
10. Hayes, R. M. i Schaefer, S. (2000) Implicit Contracts and the Explanatory Power of Top Executive Compensation for Future Performance. *The RAND Journal of Economics*, 31 (2), pp. 273-293.
11. Henderson, A. D. i Fredrickson, J. W. (2001) Top Management Team Coordination Needs and the CEO Pay Gap: A Competitive Test of Economic and Behavioral Views, *The Academy of Management Journal*, 44 (1), pp. 96-117.
12. Jensen, M. C., Murphy, K. J. (2004) *Remuneration: Where we've been, how we got here, what are the problems, and how to fix them*. ECGI Working Paper Series in Finance, Working paper No. 44/2004
13. Jensen. M. C., Meckling, W. H. (1976) Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure, *Journal of Financial Economics*, 3 (4), pp. 305-360.
14. Jones, D. C. i Kato, T. (1996) The Determinants of Chief Executive Compensation in Transitional Economies: Evidence from Bulgaria. *Labour Economics*, 3 (3), pp. 319-336.
15. Jones, D. C. i Klinedinst, M. (2006) Corporate Governance and Executive Compensation in Bulgaria after Mass Privatization: Evidence from New Panel Dana. In: Kalmi, P. i Klinedinst, M. (ed.) Participation in the Age of Globalization and Information (Advances in the Economic Analysis of Participatory & Labor-Managed Firms, Vol. 9), Emerald Group Publishing Limited, pp. 177-209.
16. Kaplan, S. N. (2006) *State of US Corporate Boards and Governance: What is Right and Wrong?*. In: Owen, G., Kirchmaier, T. & Grant, J. (ed.) Corporate Governance in the US and Europe. Hampshire: Palgrave Macmillan, pp. 38.
17. Lubatkin, M. H. (2005) A Theory of the Firm Only a Microeconomist Could Love, *Journal of Management Inquiry*, 14 (2), str. 213-216.

18. Mahoney, T. A. (1979) Organizational Hierarchy and Position Worth, The Academy of Management Journal, 22 (4), pp. 726-737.

19. Mehran. H. (1992) Executive Incentive Plans, Corporate Control, and Capital Structure, *The Journal of Financial and Quantitative Analysis*, 27 (4), pp. 539-560

20. Pederson, T. i Thomsen, S. (1997) European patterns of corporate ownership: A twelve country study. *Journal of International Business Studies*, 28 (4), pp. 759–778.

21. Shleifer, A. i Vishny, R. W. (1997) A Survey of Corporate Governance. *Journal of Finance*, 52 (2), pp. 737-783.

22. Slapničar, S., Gregorič, A. i Rejc, A. (2005) Social Comparison as Determinant of Senior Executives' Compensation. *Proceedings of the Sixth International Conference on „Entrprise in Transition"*, Crnjak-Karanović, Biljana (ed.). Split: University of Split, Faculty of Economics Split, pp. 187-204.

23. Van Herpen, M., Van Praag, M., Cools, K. (2005) The effects of performance measurement and compensation on motivation: an empirical study. *De Economist*, 153, str. 303-329.

24. Westphal, J. D. i Zajac, E. J. (1998) The Symbolic Management of Stockholders: Corporate Governance Reforms and Shareholder Reactions. *Administrative Science Quarterly*, 43 (1), pp. 127-153.

25. Wiseman, R. M., Gomez-Mejia, L. R. (1998) A Behavioral Agency Model of Managerial Risk Taking. *The Academy of Management Review*, 23 (1), pp. 140.

Preliminary Communication
UDC 005.742-055.2-057.177.3(497.5)

Mario Vinković
Zdenka Barišić

WOMEN IN BOARDS OF DIRECTORS – IS THERE A NEED FOR NORWEGIAN FORMULA IN CROATIA?

Abstract

Women are represented by a higher percentage in the total labour force of the Republic of Croatia than men and in the past couple of years there have been more female students at Croatian universities. Such trends reflect a factual situation among the general population and active labour force and it prima facie flatters the national gender equality policy, but despite that, women are not proportionally represented in the highest positions in a professional and business environment. The aim of the paper is to find the answers for under-representation and treatment of women in boards of directors of large Croatian companies as well as lege lata solutions and possible de lege ferenda changes. Moreover, in comparative perspective and analysis it tries to answer the question referring to the implementation of the Norwegian formula in Croatian circumstances.

Key words: women, board of directors, Croatian companies, Norwegian formula

INTRODUCTION

In Croatia, women are the majority with respect to the total population and the structure of education (Women and Men in Croatia 2011), but they are nevertheless affected by a higher rate of unemployment and a weaker representation in management positions (Activity Report for

2010). Moreover, it is evident that when it comes to performing the leading jobs in the hierarchical ladder, they are underpaid in comparison to their male colleagues (Activity Report for 2010). This is a reflection of the factual situation in the total population and the trend which testifies a disproportionate gender representation, i.e. gender segregation, in the top positions in a professional and business environment.

In 2003, due to gender segregation and related statistical indicators, Norway initiated amendments to the legislation regarding women's representation in boards of directors of public and private companies which made it become the first country in the world which regulated the necessity of achieving gender balance in this field. In accordance with an agreement with the private business sector, it was specified that the provisions relating to private companies should not come into effect if the desired gender balance was achieved voluntarily by 1 July 2005 (data by the Norwegian Ministry of Children, Equality and Social Inclusion). After a transitional period of two years (2006-2008) defined by the related legislation and the initial difficulties, the present situation stands in favour of 40% of women who are members of boards of directors in public companies. However, one should not cherish an illusion that the aforementioned was done without any legislative protection mechanisms, since privately owned public limited companies, under threat of dissolution, had to comply with the given standards by 1 January 2008. Interestingly, none of the companies had to be dissolved due to a failure to comply with the relevant statutory provisions (data by the Norwegian Ministry of Children, Equality and Social Inclusion). Quite expectedly, continuous technical and scientific attention has been paid to the Norwegian formula, it is exposed to numerous *pros* and *cons*, but it is certainly intriguing and thought-provoking, especially as regards the traditional societies.

Croatian society is considered to be traditional and conservative in many areas, particularly in the context of achieving equal representation of women in leading positions of power in the economy and political representative bodies. In terms of that, it is a great challenge to find answers to questions referring to representation and position of women in boards of directors in large Croatian companies, solutions *lege lata* and potential needs for changes *de lege ferenda*, and in comparative perspective to answer the question on the application of the Norwegian formula in national circumstances.

CROATIAN LEGAL FRAMEWORK, GENDER MAINSTREAMING AND STATISTICAL INDICATORS

Unlike the Kingdom of Norway that is not a Member State of the European Union but has consistently implemented the gender equality policy, by respecting the statistical indicators of its own population, the Republic of Croatia created its national framework for achieving gender equality and combating discrimination in conditions of preparation for full EU membership and harmonisation with the *acquis communautaire*. The existing legislative framework and the National Policy for the Promotion of Gender Equality clearly support the implementation of equal opportunities for women and men, but, despite relatively high quality legal solutions, a number of difficulties has been observed at a practical level. With no intention to engage in a nomotechnical analysis of the existing anti-discrimination framework, it must be pointed out that the biggest problems are reported regarding the interpretation of the existing legislation, i.e. major part of unprofessional and inappropriate interpretations of the existing solutions in the spirit of the practice of the European Court of Human Rights of the Council of Europe and, in particular, the judgments of the Court of Justice of the EU. It would not be superfluous to point out that the electoral legislation applicable to the election of representatives in the national parliament, but also the representative bodies of local and regional self-government, provides for the need for women's representation on the candidate lists of 40%. However, no single political party complies with these provisions, justifying themselves by saying that no sanctions are provided for contrary treatment. The present attitude of political parties, but also the actions of the State Electoral Commission, certainly open up a whole new debate on the interpretation, legal culture, or the absence of any rational legal reasoning, i.e. elementary legal logic - because, we dare say, even without punishment it could be interpreted that such candidate lists are to be rejected, i.e. excluded from further proceedings. But more importantly, the present attitude clearly reflects Croatia's reality.

The Companies Act of the Republic of Croatia contains numerous provisions that regulate a rather complex issue, and in professional circles it is considered to be a regulation of relatively good quality, but there is no mention of sex determinants of BoD and supervisory board members. Relevant provisions are written in a unique gender-neutral language, since both masculine and neuter nouns are used at the same time - persons and male directors as well (Articles 239 – 272(o), Companies Act), but statistical indicators stand in favour of the hypothesis on the exclusive male dominance in leadership positions in Croatian state-owned, public and private companies.

The paper will focus on the data contained in the Annual Corporate Governance Report for the year 2010 issued by the Croatian Financial Services Supervision Agency (HANFA), whose statistical indicators recorded 18.16% and 17.75% of women board members in 2009 and 2010, respectively (HANFA Annual Corporate Governance Report, 2010). Even the HANFA itself points out that global trends in the economy in terms of greater representation of women in leadership positions are not accepted in Croatia due to the confirmed positive correlation between the number of women in management positions and business performance (HANFA Annual

Corporate Governance Report, 2010). Moreover, the average number of female board members declined from 0.39 in 2009 to 0.37 in 2010 (HANFA Annual Corporate Governance Report, 2010). Namely, in 2009, there were only 4.3% of issuers on the official market in which women were BoD members (compared to 5.38% in 2010), or 27.96% of issuers on the regular market (compared to 25.81% in 2010). Thus, the total number of women executives and board members decreased in 2010 in comparison to 2009, and only 19 issuers had a female CEO (in 2010). Moreover, the latter figure represents a decrease of 5% in relation to the previous year (HANFA Annual Corporate Governance Report, 2010). On the other hand, it is interesting that the percentage of reappointments of female board members increased in 2010 and amounted to 18.6%, i.e. it was 3.29% greater than a year ago (HANFA Annual Corporate Governance Report, 2010). When it comes to supervisory boards, it should be noted that in the Republic of Croatia a supervisory board can have between 3 and 21 members, depending on the amount of issued share capital. In 2009 and 2010, women accounted for 19.7% and 20.6% of supervisory board members, respectively (HANFA Annual Corporate Governance Report, 2010). Given the potential total number of supervisory board members and the various ways of appointing members, the issue in question is more about an expected statistical event rather than a positive trend.

The aforementioned changes in the Norwegian legislation were inspired by the statistical indicators referring to a higher rate of education among women and a greater number of women in occupationally active population, and, in particular, broad political support the proposal received after intense public debates (Storvik, A., Teigen, M., 2010). Time distance clearly suggests that the percentage of women on boards increased by 34% in the period from 2002 to 2009, and reached the required gender balance of 40%. In terms of education of board members, it can be seen that 36% of female board members hold a university degree lasting for 6 years or more, as opposed to 22% of their male colleagues (Storvik, A., Teigen, M., 2010). For the purpose of comparison, in 2009, there were 56.3% of women enrolled in institutions of higher education in Croatia, they made 58.6% of graduates from institutions of higher education, and by the fields of study, they dominated the total number of graduates from institutions of higher education in Croatia in a range between 58 and 95% (including business and administration, law, physical sciences, mathematics and statistics). They are the only exception in the field of computing, where they represent 15.9% of the total number of graduates (Women and Men in Croatia, 2011).

In the analysis of 500 largest companies in Croatia by revenue, women are in leading positions in only 9% of companies, and they are CEOs in only two of the twenty leading Croatian companies (Jutarnji list-daily newspaper, 8 August 2011).

Although changing attitudes about women in the world of work in recent decades does not necessarily lead to changing attitudes about women leaders and their acceptance to occupy boss positions (Pande, R., Ford, D., 2011), statistical indicators clearly suggest the need for greater representation of women as BoD members in companies. Diversity management has been recognised as an area that, in the light of demographic changes, allows for selection, retention, and management of diverse workforce, but also the exchange of different ideas *in favorem* better business results (Best Practices in Diversity Management, 2001). Croatia, but also countries like Croatia, that have continued to record serious post-transition problems regarding the transition from dictated economic relations to a free market economy and the transition from rigid, closed political systems marked by communist and socialist history to democratic traditions and the rule of law, could use diversity management as a practical tool in the fight against discrimination in the labour market and gender segregation (Vinković, M., Bešlagić, J., 2011). This Anglo-Saxon model, which has not gained increasing attention in continental Europe in the last couple of decades, could be able to encourage not only the desired and necessary changes in such societies, but also mental transition from the society that has experienced retraditionalisation of patriarchal values (Tomić-Koludrović,1996) to a society that really lives the concept of gender equality. Such approach would enable the development of a culture that recognises and evaluates differences as a competitive advantage (Dickens, L., 1994).

EUROPEAN CONTEXT

The Norwegian formula should not be viewed as drawing water to the mill of the feminist movement, but as a reality that is, after a few years, quite reasonably analysed and applied all over Europe and the world. Following the Norwegian experience, similar debates and proposals were initiated by Germany, France, the Netherlands, Spain and Sweden, so we can no longer speak of a specific gender equality innovation that is limited only to a narrow national territory (Storvik, A., Teigen, M.,2010).

Gender equality finds its foundation in the founding treaties and the EU Charter of Fundamental Rights as a fundamental principle of the European Union. Moreover, equality between women and men is one of the EU's main objectives and tasks (Articles 2 and 3(3) of the TEU and Article 8 of the TFEU). At the average European level, women make up less than a third of business leaders (European Commission Report on Progress on Equality between Women and Men in 2010). Cyprus and Finland had the lowest scores, i.e. significantly below 30%, and the results are even more defeating when it comes to women on boards in the largest European companies. At European level, 97% of BoDs are run by men, and in 2010, women accounted for only 12% of BoDs members in the largest public companies in the EU(European Commission Report on Progress on Equality between Women and Men in 2010). In Sweden and Finland, women make up 26% of the board members; figures for Latvia, Slovakia and Romania range between 21% and 23%, while in Malta, Luxembourg, Cyprus and Italy, these data are devastating, i.e. less than 5% of board members are women (European Commission Report on Progress on Equality between Women and Men in 2010). The situation is not very different in the USA, where, according to the Catalyst Census, women hold around 15% of board seats in the companies (European Commission Report on Progress on Equality between Women and Men in 2010). Indeed, the Norwegian formula cannot be underestimated if we bear in mind the fact that closing the male-female employment gap would have positive economic results for developed economies and contribute to solving the problems posed by population ageing and the burden of pensions (European Commission Report on Progress on Equality between Women and Men in 2010).

Of course, any introduction of quotas at the same time opens debates on the issue of equal treatment and potential discrimination, in this case - of men. However, quotas or positive actions always have a clear raison d'être, and, taking into account the Norwegian experience and statistical indicators, they exclude the fear of forced recruitment of less competent and less experienced but gender-adequate workforce (Storvik, A., Teigen, M., 2010). In addition, strong social support is important, but also the willingness of employer associations to make additional efforts for the introduction of such measures (Pande, R., Ford, D., 2011).

Statistical indicators in Norway, Croatia and Europe are *pro futuro in favorem* women because of a clearly visible trend showing their greater representation in relation to men when it comes to higher education and holding university degrees. However, positions of power are held by men, so that a natural process “Wait until everything is just right” is not sufficient, since the processes of bringing change can generally be initiated only from the positions of power. Reform of the legal framework and the fight against gender segregation in the labour market, supported by normative and institutionalised mechanisms, are initial elements for “mental transition” we talk about and the basic prerequisite for social changes in terms of a greater representation of women in boards of directors and supervisory boards.

HOW TO SOLVE THE PROBLEM IN CROATIA NOMOTECHNICALLY?

The trends described, European practice and the policy of commitment to gender equality undoubtedly speak *in favorem* advocacy of quotas for women on boards in Croatian companies.

Doubts as to how to resolve this issue nomotechnically open a discussion referring to a regulation which should accommodate the provisions in relation to the quotas - Gender Equality Act, Anti-Discrimination Act or Companies Act. The Norwegian experience is in favour of the latter, i.e. the Companies Act. Characteristics of the Croatian society, problems of the interpretation and implementation of the existing solutions, clearly suggest that the aforementioned issues should be addressed through the provisions of the act regulating the status of companies, and the introduction of a system of sanctions is the only guarantee of a successful implementation.

The debate on this issue is directly linked to the quality of the legal framework for the fight against sexual discrimination and labour market segregation, but also the social perception of the role of women in the community, family and business environment. Representation of women in the current Croatian Parliament is only 20%, which makes the actual impact of women in the sphere of political decision making clear.

National legislation regulating the prohibition of gender-based discrimination cannot be considered to be of low quality, since for the most part, under the aegis of meeting conditions for full EU membership, it is a result of a politically dictated and conducted harmonisation with EU regulations. But, normative solutions, observed in correlation with the interpretation of national legislation of relatively high quality, and the situation in everyday practice and business environment, suggest a completely different picture. Underrepresentation and gender discrimination are very present. Anti-Discrimination Act and Gender Equality Act must live at both the interpretive and the implementation level, and the problem of underrepresentation of women should not be considered one-dimensionally and plastically, since such focus of evaluation would depict almost ideal national circumstances. Statistical data certainly suggest quite a different balance of power. The biggest problem are insufficient capacities for identification and social treatment of gender discrimination and labour market segregation that is a result of indirect sex discrimination (Vinković, M., 2010), and a practically useless legal definition of segregation. In national legislation, segregation is defined as "systematic" and "forced" separation on the basis of some legal ground of discrimination, so it is obvious that this is a completely impotent mechanism for a democratic society, in which segregation is most often the result of indirect (sex) discrimination (Vinković, M., 2010). It is possible to search for a legal framework of the fight against segregation only in the existing definitions of direct and indirect discrimination that, together with the proper interpretation, may offer necessary solutions. It would be desirable to integrate programme provisions on affirmative action in terms of a higher representation of women on boards of directors and supervisory boards into the Anti-Discrimination Act and the Gender Equality Act, and the provision on the required number of women on boards of directors and supervisory boards into the Companies Act. It would be necessary to divide the system of sanctions and the time duration, i.e. exercising of programme principles, into a number of regulations and integrate them nomotechnically partly into anti-discrimination laws and partly into the Companies Act.

An additional problem with the introduction of quotas might occur when it comes to wages and remuneration for female BoD members. The specificity of the Croatian law is that under the Companies Act, members of the boards of directors, as a rule, should not be employees of the related company. However, this is diametrically opposed to practice, so that in most cases these are persons with employment contracts. Basically, the Labour Act provision on equal pay for equal work and work of equal value for women and men should apply to them, but statistically it is difficult to prove compliance with that principle taken over from the TFEU. Although a great number of experts believes that there are no disputable matters with respect to salaries, since most often collective agreements apply to employees working in big systems and companies, practice suggests that memberships in boards of directors and supervisory boards are often exempt from the application of collective agreements. In terms of wages and remuneration of the given categories of employees, a remark is often entered into collective agreements and/or rule books which says that those workplaces are designated as workplaces for which a wage/remuneration is contracted individually. Therefore, it is difficult to follow and determine differences in wages of male and female board members, i.e. differences with respect to such wage contracting. The latter is additionally aggravated by common contractual provisions on confidentiality of wages and remuneration for board members, as well as various direct or indirect income and allowance that would be considered wage/remuneration in the context of European legislation, but within national frameworks these are still not treated in accordance with EU law.

Legal research and literature often neglect the need for an interdisciplinary and multidisciplinary approach to the phenomena that are subject of scientific focus. Quite a lot of sources that analyse how men and women run companies as well as advantages and shortcomings of female and male management can be found in economic literature. As lawyers, we cannot deal with a detailed analysis of the aforementioned, but we can try to use that research in the interpretive sense. Some authors undoubtedly point out that men are focused on the functions of power and the personal level, whereas women take care of others (Eagly, A.H., Carli, L. L., 2007), and run on emotions in business environment. However, empirical studies have not found any evidence that gender diversity in companies and executive positions affects financial power or makes investments exposed to risk (Adams, R., Fereira, D., 2009), so that in that sense different forms of management styles should not appear as arguments *contra* the need for a greater representation of women in boards of directors and supervisory boards. Statistical data on the recent female dominance in the student population and in the total number of university degree holders, where they make an exception only in typically male professions (engineering, mining, etc.), provide a sufficient argument for the necessary changes. At the level of BoDs and supervisory boards, the introduction of gender quotas might influence the age structure and the level of experience of female BoD and supervisory board members (Matsa, D. A., Miller, A. R., 2011) in the beginning, but in the long run it should not be prevented by various social factors opposing normative changes and regulatory intervention. On a personal level and in the sphere of private life, female board members could face gender constructs in terms of family obligations and expectations in relation to motherhood and parenting (England, P., 2005; England, P., Li, S., 2006), but such gender stereotypes should not be used as an argument against gender quotas. Moreover, the impact of the present gender stereotypes on normative changes would represent direct sex discrimination and oppose national legislation provisions on the protection of motherhood and parenting. Labour market characteristics are therefore not determined only by market legitimacy and forces, but also by actions of capitalism and patriarchy, as well as national culture and the position of women in national labour markets (Rees, B., Brewster, C., 1995). Negative perceptions and treatment of women, myths about the period of maternity due to which women are apparently not a reliable workforce, the impact of professional groups protecting their own influence and power, are the result of a negative masculine gender stereotype and masculine consciousness which feels threatened and therefore excludes women from their social interactions and relations (Lahtinen, H. K., Wilson, F. M., 1994). Resistance to women BoD members is stronger in countries and societies not aware enough, so that they show opposition to Gender Equality Policy, but noticeable differences in female and male management characteristics will gradually disappear, and the possible short-term increase in the costs of companies that introduce quotas (education, increase in the number of employees, etc.) will be replaced by long-term, cost-effective goals (Matsa, D. A., Miller, A. R., 2011). Finally, one should bear in mind that the feminisation of higher education must consequently lead to the feminisation of the leading positions (Whitehead, S., 2001).

CONCLUSION

The implementation of the women's quota system in boards of directors of Croatian companies would certainly meet a lot of resistance and unargumented criticism, and part of experts would definitely characterise the Norwegian formula in Croatian conditions as acts of political, interventional or legal feminism. However, gender stereotypes and the existing national Gender Equality Policy clearly suggest that changes are not possible without legislative action, the top-down principle and the prescribed sanctions. Moreover, both Norway and countries that follow its practice or intend to do so, although they are probably more developed in terms of raising public awareness, social treatment of the concept of equality and perception of gender discrimination, have come across a lot of resistance and expert and academic *pro* and *contra* analyses and argumentations. However, consistency with the aim and realisation of legally imposed quotas and sanctions has recorded its results and affected the fight against gender segregation. As a society characterised by "retraditionalisation of patriarchal values" and persevering gender stereotypes, Croatia cannot leave realisation of this theorem to a natural process of time, but in the spirit of accepted European policies and the promotion of European values in national frameworks, the positive examples should be followed, accepting thereby the statistical reality that the feminisation of higher education should also lead to the feminisation of the leading positions. Numerous counterarguments incurred as a result of interdisciplinary and multidisciplinary research do not contain irrefutable evidence of the low-quality Norwegian formula or its "absurd" repercussions, but to a greater or lesser extent they usually reflect present gender stereotypes of their authors.

It seems that one rich and successful non-EU member country is once again teaching not only EU Member States, but also future members how to manage. In the conditions of the financial crisis such lessons should be borne in mind.

References

1. Activity Report for 2010 of the Ombudswoman for Gender Equality, Zagreb, April 2011. Available at: http://www.prs.hr/docs/rh_prs_izvjesce_2010.pdf (Last accessed on 20 October 2011).
2. Adams, R., Ferreira, D. (2009) Women in the Boardroom and their Impact on Governance and Performance, *Journal of Financial Economics*, 94(2), 291-309.
3. Anti-Discrimination Act, Official Gazette, No. 85/2008.
4. Best Practices in Diversity Management (2001), United Nations Expert Group on Managing Diversity in the Civil Service, New York, 2001. Available at: http://unpan1.un.org/intradoc/groups/public/documents/un/unpan000715.pdf (Last accessed on 6 September 2011).
5. Companies Act, Official Gazette (Articles 239 – 272(o)), Nos. 111/99, 34/99, 121/99, 118/03, 107/07, 146/08 and 137/09.
6. Dickens, L. (1994) The Business Case for Women's Equality, Is the Carrot Better than Stick, *Employee Relations*, 16(8), 5-18.
7. Eagly, A. H., Carli, L. L. (2007) Through the Labyrinth: The Truth About How Women Become Leaders, Harvard Business School Press, Boston.
8. England, P., Li, S. (2006) Desegregation Stalled: The Changing Gender Composition of College Majors, 1971-2002, *Gender and Society* 20(5), 657-677.
9. England, P. (2005) Gender Inequality in Labor Markets: The Role of Motherhood and Segregation, *Social Politics* 12(2), 264-288.
10. European Commission Report on Progress on Equality between Women and Men in 2010, The gender balance in business leadership, Justice, 2011.
11. Gender Equality Act, Official Gazette, No. 82/2008.
12. HANFA Annual Corporate Governance Report of the issuer whose securities were listed on a regulated market in the Republic of Croatia for the year 2010, Croatian Financial Services Supervision Agency (HANFA), Zagreb, September 2011.
13. Jutarnji list - daily newspaper, (Monday, 8 August 2011) "*U Sloveniji žene vode 14.8, u EU 11.7, a u Hrvatskoj samo 9% kompanija",* p. 10.
14. Lahtinen, H. K., Wilson, F. M. (1994) Women and Power Organizations, *Executive Development*, 7(3), 16-23.
15. Matsa, D. A., Miller, A. R. (2011) A Female Style in Corporate Leadership: Evidence from Quotas (2 December 2011). Available at SSRN: http://ssrn.com/abstract=1636047 (Last accessed on 20 December 2011).
16. Norwegian Ministry of Children, Equality and Social Inclusion Data. Available at: http://www.regjeringen.no/en/dep/bld/Topics/equality/rules-on-gender-representation-on compan.html?id=416864 (Last accessed on 20 October 2011).
17. Pande, R., Ford, D. (2011) Gender Quotas and Female Leadership: A review, Background Paper for World Development Report on Gender 2012, April 2011, Harvard Kennedy School of Government. Available in pdf format at: http://www.hks.harvard.edu/fs/rpande/papers/Gender%20Quotas%20-%20April%202011.pdf (Last accessed on 6 September 2011).

18. Rees, B., Brewster, C. (1995) Supporting Equality: Patriarchy at work in Europe, *Personnel Review*, 24(1), 19-40.

19. Storvik, A., Teigen, M. (2010) Women on board: The Norwegian Experience, International Policy Analysis, Friedrich Ebert Stiftung, June 2010. Available at: http://library.fes.de/pdf-files/id/ipa/07309.pdf (Last accessed on 5 September 2011).

20. Tomić-Koludrović, I. (1996) Konstrukcija spolnosti i tolerancija, *Društvena istraživanja*, 22(2), 331-343.

21. Vinković, M., Bešlagić, J. (2011) Diversity Management – a solution for workplace discrimination in Bosnia and Croatia?, in: Barković Bojanić, I., Lulić, M. (eds.) *Contemporary Legal and Economic Issues III*, J. J. Strossmayer University of Osijek, 368-394.

22. Vinković, M. (2010) Spolna segregacija i tržište rada – hrvatski diskurs europskih trendova, in: Radačić, I., Vince Pallua, J. (eds.) Ljudska prava žena, Razvoj na međunarodnoj i nacionalnoj razini 30 godina nakon usvajanja Konvencije UN-a o uklanjanju svih oblika diskriminacije žena, Institut društvenih znanosti Ivo Pilar and Ured za ravnopravnost spolova Vlade Republike Hrvatske, 203-216.

23. Whitehead, S. (2001) Woman as Manager: A Seductive Ontology, *Gender, Work and Organization*, 8(1), January 2001, 84-107.

24. Women and Men in Croatia 2011, Report by the Croatian Bureau of Statistics, Available at: http://www.dzs.hr/Hrv_Eng/menandwomen/men_and_women_2011.pdf (Last accessed on 20 October 2011).

Review
UDC 005.7:658.115>(438)

Filip Grzegorczyk

CORPORATE GOVERNANCE OF STATE – OWNED ENTERPRISES (PUBLIC UNDERTAKINGS) IN POLAND – TWENTY YEARS' EXPERIENCE

INTRODUCTION

From 1945 to 1989, Poland was a typical centrally-planned economy. Almost all enterprises were organized as state enterprises[1]. After 1989, at the beginning of the economic transformation, there was a huge question mark over what to do with thousands of state enterprises. The answer was easy: nearly all state enterprises should be privatized.

The privatization program was partly successful, but there are still more than 500 business entities with the State Treasury as a shareholder or even sole owner (*e.g.* companies, state enterprises, foundations, executive agencies, institutions of budget economy)[2]. The majority of these established a large number of subsidiaries and became the leaders of holdings controlled by State. This is why there are so many business entities linked, directly or indirectly, with the State.

Poland never answered two basic questions concerning SOEs:

[1] Przedsiębiorstwa państwowe.
[2] See: www.msp.gov.pl

First - should enterprises remain under the control of the State Treasury or should they be privatized; and

Second - should enterprises be commercial or should they perform a public mission.

The lack of clear division of SOEs strongly impacts on their corporate governance and exacerbates the illogical behavior of SOEs. Quite often they face a conflict between the performance of public duties (which should be natural for “mission SOEs”) and economic effectiveness (natural for “non-mission SOEs”). This situation influences the corporate governance of state-owned enterprises. Phenomena having negative impact on the corporate governance of enterprises constituting state property have been discussed below.

There are many varied entities in Poland which can be qualified as state – owned enterprises. Considering the understanding of the concept of a *“public undertaking”* stemming from art. 106 of the Treaty on the Functioning of the European Union, one has to state that a public undertaking is each organizational entity running, even peripheral, business operations and which is controlled by the state. In the Polish legal order these criteria are fulfilled by - amongst others - executive agencies, institutions of budget economy, public healthcare providers, research institutes, state enterprises, commercial companies, foundations or finally entities established through individual normative acts. The way of being established, the goal or the financial management are irrelevant as to qualifying a given entity to the category of a public undertaking[3] – what is important is the running of business operations and control held by the state. In this study a broad understanding of the concept of *a state – owned enterprise*, i.e. an understanding resulting from the Law of the European Union *(public undertaking)* has been applied.

OWNERSHIP SUPERVISION & ALLOCATION OF SUPERVISORY FUNCTIONS WITHIN MINISTRIES

The issue of supervision over a public undertaking is complex. It seems obvious that public undertakings carrying out public tasks are supervised by supervisory organs from the point of view of carrying out specifically these tasks. On the other hand, the functioning of some entities in the organizational form of a company results in the fact that they have to be supervised within the so- called ownership supervision. In the second of these situations, the supervisory organ is present in the role of a representative of the owner, which is the State Treasury. The main state organ carrying out the ownership entitlement with regard to public undertakings is the minister

[3] Although these are specific factors with regard to this entity group.

for State Treasury. Unfortunately, this minister is not the only organ carrying out the ownership entitlement with regard to public undertakings[4].

In the case of entities that are not companies, what is carried out is the administrative supervision with elements of ownership supervision by a sector minister[5]. Most frequently the administrative supervision with regard to public undertakings is not purely administrative in nature. Such a situation would occur if the organ of administrative supervision over a given public undertaking pertain exclusively to the public task realized by it, without relation to issues that are typical for ownership supervision, such as for example entitlement in the scope of personnel policy, approval of strategy and investment policy, assessing the business operations of the entity. This is however a situation that is generally not encountered as well as theoretically difficult to programme.

The situation is more complex with regard to companies. Here the supervision over some companies is ‘double’, i.e. comprising ownership supervision and administrative supervision resulting from the fact of carrying public tasks by them. The execution of administrative supervision has sense only with regard to companies carrying out public tasks and should be performed by the sector minister. Corporate supervision, in theoretical terms, should be performed by a minister for State Treasury. Taking into account the fact that supervision dualism is incorrect, and the priority of companies carrying out public tasks should be their realization, one should support the thesis that the administrative and corporate supervision should be carried out jointly by a sector minister.

At this point it is worth drawing attention to a certain paradox connected with the dualism of supervision over public mission undertakings. A State Treasury company carrying out a public task, on one hand is subject to ownership supervision as a company and on the other hand – is subject to administrative supervision because of carrying out the public task. If these two supervision systems have different goals, it is natural that an evaluation conflict occurs within the two supervision types. One can easily imagine that an entity will be assessed very well as part of one supervision type, whereas the same state of affairs will be negatively assessed by the other supervision. Both evaluations can be allowed on the basis of particular supervision, but still the same entity is subject to assessment. An example may be a situation of positively evaluated company value growth (by corporate supervision) at the expense of not carrying out a financially unprofitable public task, which by nature, should be negatively assessed by administrative supervision. This paradox may take effect the other way round. A commercial company

[4] Ownership supervision is also performed by Minister of Infrastructure, Minister of Finance, etc.
[5] In this paper „sector minister” means a minister responsible for the *dossier* other than State Treasury.

continuously realizing public tasks may find itself having financial problems with regard to which corporate supervision will express its disapproval.

If evaluation is carried out by different administration organs (or different entities of the same organ) then a natural conflict occurs. However, should both assessments be carried out by the same entity then schizophrenia symptoms come into being. The indicated inconsistencies have their source in using the form of a commercial company. A simple change of the organizational form (by eliminating the form of a commercial company for mission entities) gives a chance of eliminating these inconsistencies.

The current state of affairs indicates that illogical situations may take place frequently. An example of this can be ownership and administrative supervision carried out by the minister for State Treasury or supervision carried out by different ministers (once by sector and once by State Treasury) depending on capital engagement.

The ownership supervision carried out by the minister for State Treasury is far from desired. Such an opinion results not only from a low merit standard of regulations concerning these issues, but also the practice of executing the said supervision. Bureaucratization of processes, making them subject to detailed public law regulation and high level of politicization induces a question – is the formula of running ownership supervision over companies with State Treasury is really appropriate? One may have justified doubts whether a ministry (office) will ever be able to operate in a similar way to a private corporation. Due to competences attributed to the minister for State Treasury, the proper point of reference for the function of ownership supervision of non-mission companies should be holding companies (portfolio companies) or even investment funds, whose scope of operations is managing held shares in order to increase their market value for the shareholder.

With regard to the organization of supervision over public undertakings, it is possible to draw a new model. The starting point should be a division of entities into mission entities (carrying out public tasks) and non-mission entities running standard business operations aimed at generating profit. The latter (these should operate in the organizational form typical for private law turnover) should be supervised by one organ representing the State Treasury shareholder with a reservation that it should not necessarily be a minister. The mission type enterprises on the other hand should be subject to administrative supervision carried out by ministers, whose competencies include running the government policy in the operation sphere of these enterprises. However, one should also take into consideration appointing certain joint instruments enforcing rationality and economy of the operations run by these entities. The organizational form of a company for mission type entities seems questionable.

All the above mentioned issues require legislative changes.

DIVERSIFIED STRUCTURES OF CORPORATE GOVERNANCE

The analysis of the structure of a public undertaking indicates a lack of a single model. In the group of undertakings that are not companies there are solutions like one person management, one person management *plus* type of opinion making and supervising organ (for example - director and scientific council, president and consulting board, director and employee council). In this group there is also multi-person management and an organ similar to the supervisory board in the understanding of the regulations of the commercial law[6].

These solutions only partly seem to see justification. One person management of an institution of budget economy can be justified by a limited scale of such an entity's operations. In the case of entities running large scale operations, single person management does not seem entirely safe. With reference to consultancy and supervision organs, each entity has a defined organ of that type, unfortunately of varied competence. The differentiation of competence is justified with regard to the specific character of a given entity's operations, however what lacks is the coherent regulation pertaining to general supervision over management activities – these regulations should be made uniform. Generally, one may try to distinguish two models: a model which to a certain extent copies solutions resulting from c.c.c. (but is not exactly that model) and one, which may be defined as administrative, consisting in a strong position of single-person management, deprived of actual control on the part of some supervision organ.

In the group of public undertakings that are companies, the situation seems clear although one cannot speak of full uniformity. In particular, this is visible sometimes in appointing an "additional" organ, e.g. in the form of a programme council/board. In the remaining scope, companies belonging to this group represent the model accepted in c.c.c..

The presence of various models of managing enterprises deserves partial criticism due to difficulties in business turnover resulting from this diversification. It seems justified to forward a postulate to try to uniformise the model of managing public undertakings for the purpose of attaining uniform rules of their representation in business turnover. In particular, this postulate should refer to *sui generis* entities. It would be appropriate to categorize entities and adopt uniform rules for them, at least with regard to management (the managing organ) and the supervisory organ, e.g. in the scope of common issues in the process of executing supervision.

A significant part of criticism should be devoted to internal organization of public undertakings that are companies. Regulations in this scope have to be assessed in the context of

---

[6] Commercial Company Law dated 15.9.2000, Journal of Law No 94, item 1037, with later changes, hereinafter referred to as **c.c.c.**

c.c.c. If some of the undertakings are companies, the context of company law constitutes a relatively natural point of reference. An analysis of these entities clearly indicates that the legislator created a separate legal regime with the same being chaotic, internally incoherent, rather unnecessary and inconsistent with the system of company law. This regime consists – amongst others – of regulations on appointing and dismissing members of boards, particular qualifications of organ members, particular regulations concerning organ competencies. What is worse, the particular regulations are applied with regard to defined entities on the basis of incorrect criteria[7].

The discussed state of affairs led to establishing a non-uniform type of "specialist" company, i.e. a company with the State Treasury's share. This creates a significant gap in the company law system and differentiates the legal standing of individual shareholders.

The legal regulation of public undertakings' organs is indeed very complex. There are many such regulations which in a casuistic way change well – established codes (for example l.c.p.[8] constitutes a far reaching *lex specialis* with regard to c.c.c.). The order of organs, their competencies, mutual relations are frequently unclear. What draws attention is for example the procedure for appointing organs (together with varied construction of nomination entitlement of particular administration organs), their varied competencies or finally rules of operation.

It seems that in an obvious way these aspects indicate the weaknesses of regulating public undertakings and immediate need of reforming this regulation. One can also clearly see that a new method of regulation is required. Instead of partial, fragmentary law, it is necessary to strive for regulations of code type, aspiring in a complete, synthetic and general way to standardize a whole set of issues. In this context its seems that one can formulate a justified thesis that variety being an immanent feature of the current regulation is not justified on a methodological and know how basis. It can be reduced without harming the quality of the regulation.

SYSTEM OF TRAINING AND ASSESSMENT FOR CANDIDATES WISHING TO BECOME BOARD MEMBERS

The already mentioned Law on commercialization and privatization regulates the issue of functioning of the State Treasury companies' supervisory boards. In particular, one should

---

[7] E.g. adopting the criterion of over 50% State Treasury capital engagement instead of State Treasury maintained control criterion.
[8] Law on Commercialization and Privatization dated 30.8.1996, Journal of Law No 118 item 561, with changes, hereinafter referred to as **l.c.p.**

indicate art. 12 clause 2, which states that members of supervisory boards of companies wholly owned by the State Treasury created in the commercialization[9] mode can be recruited only amongst persons who have passed an appropriate exam. In line with art. 69a clause 2 l.c.p., to be allowed to hold positions of supervisory boards members in companies with the share of the State Treasury, only people who have passed the said exam may be appointed as representatives in these entities.

Art. 12 clause 7 l.c.p. authorizes the Council of Ministers to define on the basis of a decision - amongst others - the requirements which should be fulfilled by candidates for members of supervisory boards, the scope of binding subjects of training and exams, the procedure of appointing the examination board, passing exams and conditions according to which the candidate can be made exempt from the obligation of passing the exam. The regulations of the law are elaborated on in the Decision of the Council of Ministers on training and exams for candidates for members of supervisory boards of companies of which the State Treasury is the sole shareholder dated 7th September 2004[10].

The content of the decision allows to assume that both the training of candidates itself as well the method of checking knowledge are imperfect. The exam is theoretical in nature, it is directed at checking formal qualifications and does not verify real qualifications. The minimum training and exam programme do not seem adjusted to economic reality, not to mention the apparent know-how and methodology mistakes[11].

PRINCIPLES OF REMUNERATION (CHIMNEY LAW)

The issue of remunerating people holding positions of members of organs in some legal persons was regulated in the Law on remunerating persons managing certain legal entities[12]. This law in

---

[9] Commercialization is the process of transforming of the state enterprise in a commercial company (organizational form changes, the owner remains the same).

[10] Journal of Law No 198, item 2038, with changes.

[11] See more: F. Grzegorczyk, Zasady i tryb doboru kandydatów do rad nadzorczych spółek akcyjnych Skarbu Państwa *(Rules and procedures of selecting candidates for supervisory boards of State Treasury joint stock companies)*, Scientific Papers of the Cracow University of Economics, 2010, No 816, pp. 76-78. The rules and procedure of selecting candidates for supervisory board membership of commercial companies with State Treasury share are regulated by Decision No 45 from 2005 and Decision No 45 from 2007. The procedure foreseen by the Decisions is faulty. The selection of members of supervisory boards only seemingly has objective nature; in practice the selection is *stricte* political. Similar theses have been expressed in the press: see e.g. P. Wiatrowski, Trzeba wyeliminować niejawność *(Secrecy must be eliminated)*, Gazeta Prawna dated 13.05.2011.

[12] Law on Remunerating Persons Managing Certain Legal Entities dated 3.8.2000, Journal of Law No 26 item 306, hereinafter referred to **l.r.p.m.**

particular limits the amount of remuneration by introducing four categories of benefits. The basic benefit is the amount of monthly remuneration defined as the multiplicity of average monthly remuneration in the enterprise sector[13]. The second type of benefit, regulated in art. 10 l.r.p.m., is the so-called annual bonus. The third type of benefit are the so-called additional benefits regulated in art. 5 clause 2 and 11 l.r.p.m.. The fourth type is severance pay defined in art. 12 of the said law.

Starting with the maximum amount of monthly remuneration, discussed in art. 8, this is a sixfold of average monthly remuneration and pertains to people managing the following entities: state enterprises, state organizational entities possessing legal form which are not at the same time state agencies, research institutes and universities/higher education bodies, companies of commercial law entirely owned and created by the State Treasury or entities of territorial self-government and companies of commercial law, in which the share of the State Treasury or entities of the territorial self-government exceeds 50% of initial capital or 50% of the share number, as well as state agencies, research institutes and some foundations created or supervised by the minister or a central organ of state administration[14].

The maximum remuneration in the amount of a fourfold of the average monthly remuneration refers to people managing such entities like: self-government organizational entities of legal status, which at the same time are not companies and commercial law companies, in which the whole or majority share of the State Treasury or territorial self-government exceeds 50% of initial capital or 50% of the share number. The remuneration is also received by people managing state agencies, research institutes and foundations created or supervised by an entity of the territorial self-government or area administration organs and heads of independent public healthcare units[15].

A onefold of monthly remuneration is an entitlement to members of supervisory organs of some organizational entities, in particular of supervisory boards and audit boards[16].

The second benefit (optional) may be an annual bonus dependent on achieved financial results or degree of other tasks' realization. At this point it is worth noting that the amount of the annual bonus cannot exceed by threefold the average monthly remuneration in the year preceding the one in which the bonus is granted[17].

---

[13] Art. 8 l.r.p.m..
[14] Art. 8 item. 1, 3, 5a in relation to art. 1 item 1, 2 l.r.p.m., art. 1 items 4-6 l.r.p.m.., art. 1 items 8-10 l.r.p.m..
[15] Art. 8 p. 2 in relation to art. 1 item 3 l.r.p.m., art. 8 p. 4 in relation to art. 1 item 7 l.r.p.m., art. 8 item 5 in relation to art. 1 items 8-10 l.r.p.m., art. 8 item 10 in relation to art. 2 item 10 l.r.p.m..
[16] Art. 8 item 8 in relation to art. 2 item 7 l.r.p.m..
[17] Art. 10 clause 6 l.r.p.m..

Subsequently, the additional benefits include various benefits resulting from employment including life, social, transport, property and personal insurance with the maximum value of additional benefits not exceeding a twelvefold of average monthly remuneration used for establishing the monthly remuneration of these persons[18].

Art. 12 l.r.p.m. foresees a possibility of granting severance pay in an amount not higher than a threefold of the average monthly remuneration in an instance of dismissal from position or termination of employment contract or civil-law contract constituting a basis for employment if these occurrences took place because of reasons other than violation of basic obligations resulting from the employment relationship.

The presented solutions have been subject to long lasting criticism, especially with regard to those entities covered by it, i.e. those which run business operations. The criticism of this law pertains chiefly to its isolation from market conditions. One should notice that remunerations in commercial business operations are not related to remuneration formed in the public sphere. The main pathology of a system functioning on the basis of the said law is its limited flexibility. The creation of maximum remuneration thresholds has led to the formation of a practice consisting in defining the maximum level for both members of the managing board as well as supervisory boards of particular companies subject to the law. Thereby, the remuneration of boards members in the company managing the power supply system of the entire country and the remuneration of a small transport enterprise realizing chiefly tasks in the scope of local area dimension are *de facto* the same. It is necessary to show that the scale of engagement in the execution of the function, the scale of responsibility and essential competences of people managing these entities are strikingly different. Because of that reason the system is improper.

Another example of imperfectness of the existing system is the comparison of remuneration of people managing two entities operating in the same field, characterized by a similar economic potential. Some time ago the remuneration of board members of a bank which was private was ten times higher than the remuneration of board members of a bank controlled by the state. So far reaching differences in the scope of remuneration in the private sector and the public sector (although commercial) in a natural way result in drainage of best personnel to the former and appointment of persons of limited competence in entities belonging to the latter of the stated sectors.

Additionally, it is necessary to notice that the method of forming remuneration is rigid and thereby de-motivating for persons in the managerial organs. The maximum base annual remuneration (seventy-two times) together with additional benefits (twelve times) in comparison to maximum amount of annual bonus (eighteen times) best show the state of affairs. The annual

---

[18] Art. 11 l.r.p.m..

prize, being a type of bonus, which may be granted in defined circumstances, i.e. being a part of remuneration of motivational character, constitutes only 21% of entire annual revenue of a person holding a position of a managing board member[19].

EMPLOYEE PARTICIPATION IN CORPORATE BODIES

In line with art. 11 clause 1 l.c.p., in the first supervisory board of a company formed in result of commercialization, there are two representatives of employees. According to art. 12 clause 1 l.c.p., at the time when the State Treasury remains the only shareholder in a company established in result of commercialization, 2/5 of the composition of the supervisory board constitute people chosen by employees, with a binding obligation of passing an exam. In line with art. 14 clause 1 l.c.p. with the moment when the State Treasury ceases to be the only shareholder of a company established in result of commercialization, the provisions of the articles pertaining to appointing and dismissing members of the supervisory board may be changed, with the employee entitlement being without a time limit. Employees maintain the right to choose two members of the supervisory board numbering up to six members, three members of the supervisory board in a board comprising from seven to ten members and four members of a supervisory board in a board numbering from eleven or more members.

The participation of employees in the work of a supervisory board may bring about mixed judgment[20]. Literature stresses that placing employees in a supervisory board is not an optimum solution as a supervisory organ should be of specialist character[21]. Although it is difficult to *a priori* exclude professionalism of employee members of supervisory boards, however practice shows that generally these are not always professionals. It is worth stressing that the share of employees in a supervisory board, taking into account its competencies, does not grant the so-called social party any real influence on the functioning of the entity.[22]

The participation of personnel representatives may be creative from the point of view of the company supervisory organ's work as it allows the organ to gain information from a different source than the managing board. On the other hand, the participation of supervisory board

---

[19] With the assumption of defining all remuneration constituents at the highest level permitted by the regulations of the law.
[20] See e.g. J. Boć, M. Guziński, T. Kocowski, Uczestnictwo pracowników jednoosobowych spółek Skarbu Państwa w radzie nadzorczej *(Participation of employees of State Treasury wholly owned companies in the supervisory board)*, Przegląd Prawa handlowego *(Commercial Law Review)* 1997, No 4, pp. 1 – 7.
[21] E. Płonka, Przekształcenie przedsiębiorstwa państwowego w spółkę *(The transformation of a state enterprise into a company)*, Przegląd Ustawodawstwa Gospodarczego *(Business Law Review)* 1990, No 1, p. 8.
[22] Ibidem, p. 8.

employee members in the work of supervisory boards may also bring about negative consequences. The work of a supervisory board with the participation of employees is surely more difficult in the context of confidentiality regarding the discussed issues.

Furthermore, the practice of functioning of the said supervisory boards show that members chosen by employees treat representing employee interests as priority and place these higher than the company's benefit. At this point, it is necessary to notice that Polish legislation foresees that protection of employee rights should be a priority for union organizations and not supervisory boards.

The no time limit frame of employee entitlement should also be criticized. Although employee entitlement in companies wholly owned by the State Treasury can be explained by a conscious state policy supporting the so-called social party, then in the case of private companies, which historically came into being in result of commercialization, such a justification is difficult to accept. An additional argument for the existing solution is the fact that the legislator, contrary – for example to the German legislator – had not decided to introduce a general regulation, which would require appointing employee members of supervisory boards in all companies. Moreover, connecting employee entitlement with the historical process of commercialization seems in the current reality to be pointless.

The Law on commercialization and privatization also foresees an entitlement of employees to choose a so-called employee member of the managing board. In line with art. 16 clause 1 l.c.p., in companies that came into existence in result of commercialization, as well as after the sale by the State Treasury of more than half of company shares, the employees choose one member of the managing board if the average annual employment in the company is above five hundred people. The issue of appointing an employee member of the managing board seems complex. To the faults of the art. 16 l.c.p. foreseen solution one has to include all those which refer to the participation of employee members of supervisory boards.

It is necessary to notice that whatever may be the opinion on the participation of employees in corporate organs, world literature stresses that this is a nearly obvious feature drawing to a certain degree from various ideas like the social teachings of the Catholic church on the one hand and socialism on the other. The participation expresses a conviction that employment relationship not necessarily should be closed in the formula of remuneration as the only equivalent for rendered work. What is more – employees should have a possibility of voicing their opinions with regard to issues that are key to their place of work and even co-decide on its fortune[23][24]. The

[24] See more in: J. Wratny, Prawo pracowników do informacji i konsultacji w świetle Dyrektywy 2002/14 Wspólnoty Europejskiej *(The entitlement of employees to information and consultation in the light of Directive 2002/14/EC)*, Państwo i Prawo *(State and Law)* 2006, No 8, p. 48.

representation of employees in company organs is currently considered in many West European countries[25] as standard[26]. It constitutes a manifestation of social market economy permeating into company law[27].

CONCLUSIONS

In conclusion, one has to notice that the corporate governance of enterprises constituting the property of the state, may be characterized as follows:

1) Illogical ownership supervision – despite the fact that there exists a minister for State Treasury, many other ministers perform ownership supervision functions for selected companies. Poland violates the principle of separation between *dominium* and *imperium*;
2) The allocation of supervisory functions within ministries causes bureaucratic behavior among people engaged in performing supervisory functions;
3) The poor performance of boards, due to selection based on political criteria;
4) Flawed system of training and assessment for candidates wishing to become board members;
5) The principles of remuneration, according to the so-called chimney law, are non-market oriented and illogical;
6) Employee participation in supervisory and managing boards is also harmful.

These are the reasons why Polish legislators should take steps to change this situation, at least by:

[25] R. H . van Het Kaar (in the study Employee Board – Level Representation in the EU: A Contested Subject, European Company Law 2009, 6, No. 2) gives numerous examples. Swedish law allows employees to choose 2 members in the director board, three in a company employing more than 1000 employees (p. 56). Dutch law is the most complicated, but the employee board can de facto appoint 1/3 of the members of the supervisory board (pp. 56 – 57). Austrian law is similar (p. 57). In turn Danish law allows employees to appoint at least two members and maximum half of the board membership (p. 57). In Luxemburg 1/3 of the board in private enterprises constitute employee representatives whereas in boards of enterprises with at least 25% state capital there must be at least 3 employee representatives, however they cannot comprise more than 1/3 of the board membership (p. 57). The regulation seems not to work in reality in Finland. See more in: L.L. Hansen, Employee Representation on the Board of Director of a Company with its Registered Office in a Nordic Country, pp. 68 – 87, R. Stroinski, Employee Participation in Companies' Boards in Poland and Selected CEE Jurisdiction, pp. 82 – 87 and F. Carl, Report from France, pp. 87 – 94, all published in European Company Law 2009, 6, No. 2.

[26] See M. Gładoch, Uczestnictwo pracowników w zarządzaniu zakładem pracy (problemy terminologiczne) *(Participation of employees in managing the entity employing them (terminology problems))*, Przegląd Prawa Handlowego *(Commercial Law Review)* 2001, No 5, p. 35.

[27] A. Chłopecki, „Socjalna gospodarka rynkowa" i prawo akcyjne *(„Social market economy" and share law)*, Przegląd Prawa Handlowego *(Commercial Law Review)* 1992, No 3, pp. 14 – 16. The author broadly presents the German regulation in this scope. See also the interesting studies of: B. Waas, Codetermination at Board Level in Germany, European Company Law, 2009, (6) No 2, pp. 62 – 67, R. Föh, Co-determination at Management Level: Germany and the Netherland, Tilburg Law Review 2008, vol. 14, no. 1&2, pp. 145 – 193.

- creating an appropriate classification of SOEs (some should remain under State Treasury control, but others should be privatized; “mission SOEs” should be clearly selected and treated differently than commercial, “non-mission, SOEs”);
- establishing a private law agency (a kind of a portfolio company) for all “non-mission SOEs” and making them fully subject to ordinary commercial law; the agency should be a unique body that exercises ownership rights in a manner typical of private ownership;
- establishing a unique legal form (other than a company) for “mission-SOEs” and making them subject to special public law regulation; these enterprises should be supervised in the context of their mission, not their financial achievements.

Preliminary Communication
UDC 34:<005.7:658.115>(497.5)

Hana Horak
Nada Bodiroga Vukobrat
Kosjenka Dumančić

LEGAL ASPECTS OF CORPORATE GOVERNANCE IN CROATIA: ISSUE OF STATE OWNED COMPANIES

Abstract

Corporate governance in Croatia is in continuous process of development and improvement.
Numerous changes in Croatian company law and corporate governance have been done in past decade mainly as a result of compliance with acquis communitaire of the EU. In that process the importance of corporate governance and the idea of implementation of good corporate governance have become more and more important. The provisions of the Companies Act in Croatia provide comprehensive legal regulation of the scope of the activities of the joint stock companies' body. Above mentioned harmonisation process with EU legislative and regulatory practice has revealed a need to adopt a corporate governance Code, to regulate where the act stops.
Recent corporate scandals in Croatia have shown that numerous problems persist beyond the fact that regulatory framework exist (both hard law and soft law instruments). In Croatian legislation has been perceived the importance of soft law instruments but some important real implications in practice doesn't exist.
Implementation of Code of corporate governance should be the top of corporate governance culture but it should be borne in mind that without real willingness to apply non binding rules there cannot be development of real corporate culture.
Special problem are state owned companies where have been introduced some newly adopted laws and regulations. The state ownership in a public context is often a complex given. The capital structure and legal structure of state owned companies is often atypical in comparison to private sector companies. The state as an owner also has different functions that may influence the working conditions of state owned companies. Problem is also implementation in practice and raising the legal culture of all stakeholders. Successful implementation of good

corporate governance standards means reducing corruption, developing quality management, preventing financial crisis, ensuring equal attitude to all shareholders and fair attitude to all stakeholders.

INTRODUCTION

Corporate governance is one of the key elements in building peoples trust on the single market. It contributes to the competitiveness of European business because well run sustainable companies are best place to contribute to the ambitious growth set up by Europe Agenda 2020 (EUROPE 2020, A strategy for smart, sustainable and inclusive growth /* COM/2010/2020 final, European Commission, 3. March 2010). To achieve these goals set in the transitional countries there is an essential need to conduct privatisation devising new rules in companies and to establish all the necessary institutions responsible for efficient functioning of the market economy. The focus should be on reducing corruption, preventing financial crisis, ensuring equal position to all shareholders (Horak, H., Dumančić, K., 2011) and of course stakeholders. To achieve these goals three areas are significant. The first of them is the effective enforcement of corporate governance rules in South Eastern Europe (OECD guidelines: State-Owned Enterprise Governance Reform An Inventory of Recent Change 2011) which should come from effective enforcement of existing laws and regulations, the second important issue is active role of boards in corporate governance reform process and the third is disclosure of financial and non-financial information.

In Croatia corporate governance needs further support of public policy because good corporate governance cannot develop without appropriate public policy which means adequate legal and regulatory framework. Corporate strategy formation is made within the set of rules which may include private self regulation but consist mainly of public laws, securities regulation, listing requirements and insolvency regulation (Nestor, S., Yasui, T., Guy, M.L.). The importance of corporate governance in context of transition has been pointed out in a number of studies, documents and articles (OECD Privatising State-Owned Enterprises: An overview of Policies and practices in OECD countries, 2003; OECD Guidelines: State Owned Enterprise Governance Reform an Inventory of Recent Change, 2011; Nestor, S., Yasui, T.; Guy, M.L.). The conclusion is that corporate governance is essential for transition economies to build well functioning institutions for economic growth. Corporate governance leads to allocation of capital and contribute on the development of financial markets and what is of outmost importance, the good corporate governance attracts foreign investment (Nestor, S., Yasui, T., Guy, M.L.). Bearing in mind outcomes of privatisation in transitional countries there are always a lot of unsolved problems such as a number of private shareholders without a proper rights and responsibilities and undefined in a practice role of boards and managers (agent principal problem). Of course there are also major obstacles which are coming from ineffective enforcement of existing laws and regulations, lack of sanctioning powers, independence of regulators, etc.

The Company Law as the core of the corporate framework developed in Croatia through the last twenty years (trying to overcome the gap between the developed countries, where the corporate governance systems has been developed through the centuries, in transitional countries the system has been developed in a vacuum, without adequate institutional support in past twenty years). But, we should bear in mind that the law in many cases neither provide sufficiently clear and efficient set of rules nor well implemented rules due the lack of proper enforcement mechanism.

ACHIEVEMENTS IN CROATIA

There were numerous changes in Croatian company law and corporate governance that have been done in past decade mainly as a result of compliance with *acquis communitaire* of the EU. In that process the importance of the corporate governance and the idea of implementation of good corporate governance standards have become more and more important (Horak,H., Dumančić, K.: Usklađivanje u području prava društava Republike Hrvatske s pravnom stečevinom EU, Pravo i porezi, br.5, 2011). The provisions of the Companies Act ((Official Gazette 111/93, 34/99, 121/99, 52/00, 118/03, 107/07, 146/08, 137/09) in Croatia provide comprehensive legal regulation of the scope of the activities of the joint stock companies' bodies. Other regulations in this area that should be mentioned are the Court Register Act (Official Gazette 1/95, 57/96, 1/98, 30/99, 45/99, 54/05, 40/07, 91/10), the Accounting Act (Official Gazette 109/07), the Auditing Act ((Official Gazette 146/05, 139/08), the Capital Market Act (Official Gazette 88/08, 146/08, 74/09) and different implementing regulations. Also for the issuers whose securities are admitted to the regulated market applies Zagreb stock exchange rules (ZSE Rules, Zagreb, May 2011, available at http://www.zse.hr/UserDocsImages/legal/Pravila%202011_EN.pdf).

Above mentioned harmonisation process with EU legislative and regulatory practice has revealed a need to adopt a Corporate Governance Code to regulate where the act stops (Horak, H., Bodiroga Vukobrat N.: *Kodeksi korporativnog upravljanja-instrument socijalno odgovornog gospodarenja*, *Socijalno odgovorno gospodarenje*, Zbornik radova, Tim press i Pravni fakultet Sveučilišta u Rijeci, Zagreb, 2008; Veršić-Marušić, M.: Zašto kodeks korporacijskog upravljanja?, Hrvatska pravna revija, 12/2004, p. 31-39).

The Corporate Governance Code was first created in 2007 by the Croatian Financial Services Supervisory Agency (HANFA) and Zagreb Stock Exchange. It was amended in 2010 (see more about corporate governance codes Horak, H., Bodiroga Vukobrat N.: *Kodeksi korporativnog upravljanja-instrument socijalno odgovornog gospodarenja, Socijalno odgovorno gospodarenje*, Zbornik radova, Tim press i Pravni fakultet Sveučilišta u Rijeci, Zagreb, 2008.).

The regulatory framework in Croatia is harmonized with European Union and within the regulatory framework all the regulations and directives are implemented. In this area implemented are Directive 2004/109/EC of the European Parliament and of the Council of 15 December 2004 on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market and amending Directive 2001/34/EC (*OJ L 390, 31.12.2004, p. 38–57),* Commission Directive 2007/14/EC of 8 March 2007 laying down detailed rules for the implementation of certain provisions of Directive 2004/109/EC on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market (*OJ L 69, 9.3.2007, p. 27–36),* the "Prospectus Directives": Directive 2001/34/EC of the European Parliament and of the Council of 28 May 2001 on the admission of securities to official stock exchange listing and on information to be published on those securities (*OJ L 184, 6.7.2001, p. 1–66)* and Directive 2003/71/EC of the European Parliament and of the Council of 4 November 2003 on the prospectus to be published when securities are offered to the public or admitted to trading and amending Directive 2001/34/EC (OJ L 345, 31.12.2003, p.64), Directive 2003/6/EC of the European Parliament and of the Council of 28 January 2003 on insider dealing and market manipulation (market abuse) (*OJ L 96, 12.4.2003, p. 16–2)* and Directive 2007/36/EC of the European Parliament and of the Council of 11 July 2007 on the exercise of certain rights of shareholders in listed companies (*OJ L 184, 14.7.2007, p. 17–24)*. Directive 2008/11/EC of the European Parliament and of the Council of 11 March 2008 amending Directive 2003/71/EC on the prospectus to be published when securities are offered to the public or admitted to trading, as regards the implementing powers conferred on the Commission (*OJ L 76, 19.3.2008, p. 37–38)* and Directive 2010/78/EU should be also implemented. Also within the recent proposals, on October 25, 2011 the EU Commission has proposed amendments to the existing Directive on transparency requirements for listed companies and to the Directives on accounting rules for annual accounts and consolidated accounts in order to close the existing gap in the notification requirements (Available at: http://europa.eu/rapid/pressReleasesAction.do?reference= IP/11/1238 & format =HTML&aged=0&language=en&guiLanguage=en).

Article 272 p of the Croatian Companies Act contains "comply or explain" (Horak, H., Bodiroga-Vukobrat, N.: EU Member States' Experiences with the 'Comply or Explain' Principle in Corporate Governance, Croatian Yearbook of European Law and Policy, Vol. 7, 2011) principle as it was introduced in the Directive 2006/46/EC of the European Parliament and of the Council of 14 June 2006 amending Council Directives 78/660/EEC on the annual accounts of certain types of companies, 83/349/EEC on consolidated accounts, 86/635/EEC on the annual accounts and consolidated accounts of banks and other financial institutions and 91/674/EEC on the annual accounts and consolidated accounts of insurance undertakings (*OJ L 224, 16.8.2006, p. 1–7)*. It contains requirement for listed companies to include corporate governance statement in their annual report, containing description of the main features of the company's internal control and risk management systems in relation to the financial reporting process. It mandates the application of corporate governance codes either by way of "comply or explain" or alternatively it allows the application of companies' specifics extra legal principles (Horak, H., Dumančić, K., Pecotić Kaufman, J.*: Uvod u europsko pravo društava*, Školska knjiga, Zagreb, 2010).

Some authors believe that the German code should be used as a model, given the fact that the Croatian Companies Act is closest to the German Akt-G (Barbić, J.: *Utjecaj njemačkog prava na stvaranje hrvatskog prava društava*, Zbornik radova Pravnog fakulteta u Splitu, god. 44., 3-4/2007).

Although is this idea in principle correct, Croatian particularities, especially those of the Croatian financial market as well as the maturity of corporate governance tradition in the Republic of Croatia should not be overlooked (Veršić-Marušić, M.: Zašto kodeks korporacijskog upravljanja?, Hrvatska pravna revija, 12/2004, p. 31-39). Numerous companies in the Republic of Croatia have their own corporate governance codes that can also be included in the annual report within the meaning of Article 272p of the Companies Act (Horak,H., Bodiroga-Vukobrat, N.: EU Member States' Experiences with the 'Comply or Explain' Principle in Corporate Governance, Croatian Yearbook of European Law and Policy, Vol. 7, 2011). In 2011. Croatian Financial Services Supervisory Agency (HANFA) have started with issuing Annual report on corporate governance in Croatia for 2010 in comparison with the data from 2009 (www.hanfa.hr). This comprehensive report is of outmost importance and shows the achievements and development of corporate culture in Croatia.

APPLICATION OF THE CORPORATE GOVERNANCE CODE IN CROATIA

In 2009 according to the data from HANFA Report on corporate governance (p. 60, available at http://www.ripe.hanfa.hr/hr/publiciranje/izvjesca/) based on data of the Zagreb Stock exchange 91 issuers delivered fulfilled questionnaire on the application of the Corporate Governance code. It presents the 39,74% of the total number of persons obliged for the data delivery. In 2010 the same questionnaire was delivered from 148 issuers (data available on 31 July 2011) and it presents 71,15% of the total number of the persons in charge for the data delivery. We can conclude that the number has increased for 31,41%.

According to the questionnaire 28 issuers additionally apply some other Corporate Governance code and 9 of them use their companies' specific code. 95 issuers publish data on their web site, 90 don´t publish, and others didn´t answered the question. Only 125 issuers who are applying the Corporate Governance codes answered that 66% of them fully comply with the Corporate Governance code. According to the shown data it seems that the level of corporate governance culture is currently rising. It is obvious that this achievement is outcome of high level of Croatian legislative and regulatory framework alignment with the EU legal framework. However recent business practice shows that Corporate Governance experiences have not been really complementing this gap between legal and business practice. That only recently resulted in numerous corporate abuses, presently awaiting resolution in court proceedings. Only time will tell whether the court epilogue could influence the development of the Corporate Governance culture or raise the awareness of Corporate Governance and management to the benefit of the company itself and thus its shareholders as well.

SPECIAL QUESTION – STATE OWNED COMPANIES

According to the Report on the operations of the companies of special national concern (The Government's report on the operations of companies of special national concern for 2009 available at the Web site of the Croatian Parliament http://www.sabor.hr/Default.aspx?art=35628) in line with the Decision of the Croatian Parliament concerning a list of companies of special national interest (Official Gazette 132/2009, 56/2010) in Croatia there are 69 companies (some of the reports on these companies are accessible on the pages of Zagreb stock exchange and HANFA) that have a special status. The Government is a majority owner in 21 of these companies. In short, these companies that in 2009 employed 110.504 people, had expenditures of 76.8 billion kunas and revenue of 74.1 billion kunas, thus making in 2009 a net loss (after taxation) of 3.5 billion kunas. Twenty eight companies made a pre-tax profit of 1 billion kunas, and 41 a net loss after taxation of 4.5 billion kunas (Bajo, A.: Companies of Special National Interest in Croatia, Press Release, Institute for a Public Finance, Zagreb, October 19, 2010, p. 1. Available at http://www.ijf.hr/eng/releases/25.pdf).

These companies are mainly in energy, agriculture, tourism, shipbuilding and financial sector. According to the Institute of Public Finance (Bajo, A., 2010) the review of this companies shows that the influence of the government has been retained despite of the all the privatizations in the last twenty years. The analysis has been brought up showing facts and the problems in terms of credit analysis but also through that analysis comes out that there is considerable number of these companies that have structural problems. Authors are pointing out that result of the report is in fact an excellent opportunity for the government to come out clearly about the status of most of the companies in which the government has a stake of less than 25%, as well as of companies that irrespective of the size of the government's equity are a burden on the central government budget and on the taxpayer (Bajo, A., 2010). For years now some of these companies have contributed nothing to the growth of GDP in spite of their privileged positions of "natural" monopolists, while the government has additionally gone in debts by issuing guaranties for their credit liabilities. In the report there are missing concrete proposals and conclusions concerning future steps in the restructuring and privatization of the companies (Bajo, A., 2010). To achieve this, there should be, as mentioned before, the legal and regulatory framework for state owned companies which should ensure level plain field in markets where state owned enterprises and private sector companies compete in order to avoid market distortions (OECD Guidelines on corporate governance on State-Owned enterprises 2005, p.18). The main idea is that there should be a clear separation between the state ownership function and other state functions that may influence the conditions for state owned enterprises particularly with regard to the market regulation (OECD Guidelines on corporate governance on State-Owned enterprises 2005, p.18). Concerning the state acting as an owner, a number of countries have developed or revised ownership policies since 2005 weather through the legislation, government approval or specific documents, or by the approval of the code for conduct of state-owned companies (State-Owned Enterprise Governance reform: An inventory of recent change OECD 2011, p.7). The significant changes have taken place in the organization and corporate governance of state owned companies over the last six years. According to the information form OECD member countries the change has been concentrated mainly in the area of: the state acting as an owner, transparency and accountability and the functioning of state owned companies boards (State-Owned Enterprise Governance reform: An inventory of recent change OECD 2011, p.7).

In Croatia there have been a several attempts of building up regulatory framework of the functioning of the state owned companies and in the moment it consists of different acts and ordinances: Definition of companies of special state interest has been developed in 2006, 2009 and 2010 by the Decision on the list of legal entities of special state interest (published in Official Gazzette 144/2010). State owned companies are also regulated by the Act on the management of state assets (Official Gazette 145/10) and managed by the Agency for the Management of State Assets (AUDIO). Agency for the Management of State Assets is regulated by the Act on the Management of state assets (Article 12) and it was founded in 2010. Other legal sources defining this area are Ordinance on the Sale of Shares and Equity in the Companies Owned by the Republic of Croatia, Institutes and Other Legal Entities Owned by the Republic of Croatia (Official Gazette 64/11), Ordinance on Manners of Performing Public Tender for the Members of

Supervisory and Management Boards of Companies Whose Shares or Stocks are Owned by the Republic of Croatia (Official Gazette 95/10) and the Code of Corporate Governance of Companies Whose Shares or Stocks are Owned by the Republic of Croatia (Official Gazette 112/10).

CONCLUSION

What remains is obligation to draw up proposals for Strategy for the Privatisation of the Companies Owned by the State and a Plan for privatisation of the Companies owned by the state. Of course there should be also pointed out the deadlines, publically available information, value of assets liabilities of state owned companies, strategic plans of companies, structural problems, etc.

Greater public attention must be directed toward the management of government financial and non financial assets because of the poor financial effect on the budget and poor corporate governance (Bajo, 2010). By joining the EU Croatia will be a part of the larger market and management of state owned companies' assets is crucial prerequisite for the stabilisation and long term financial sustainability of public sector. Greater transparency, independence and accountability should be achieved through the implementation of the corporate governance instruments. All stakeholders should be involved in this process. Corporate governance should have important spill over effect on society as a whole. Unreliable and opaque corporations are more than likely to undermine the rule of law and the effectiveness of government, creating and sustaining a vicious circle of corruption, bribery and mismanagement not only in the private sector but also in the public sector. The development of good corporate governance can be seen as a key public institution building ingredient for a transparent and accountable society. We should all bear in mind that the core values of corporate governance – fairness, transparency, responsibility, and accountability – are also the core values of democracy (Available at CIPE Center for International private enterprise, available at http://www.cipe.org/programs/corp_gov/index.php).

References

1. Bajo, A.(2010): Companies of Special National Interes tin Croatia, Press Release, Institute for a Public Finance, Zagreb, October 19, 2010, p. 1. Available at http://www.ijf.hr/eng/releases/25.pdf
2. Barbić, J.(2007): *Utjecaj njemačkog prava na stvaranje hrvatskog prava društava*, Zbornik radova Pravnog fakulteta u Splitu, god. 44., 3-4/2007.
3. Horak, H., Bodiroga-Vukobrat, N.(2011): EU Member States' Experiences with the 'Comply or Explain' Principle in Corporate Governance, Croatian Yearbook of European Law and Policy, Vol. 7, 2011.
4. Horak, H., Bodiroga Vukobrat N.(2008): *Kodeksi korporativnog upravljanja-instrument socijalno odgovornog gospodarenja*, *Socijalno odgovorno gospodarenje*, Zbornik radova, Tim press i Pravni fakultet Sveučilišta u Rijeci, Zagreb, 2008
5. Horak, H., Dumančić, K.(2011): Jačanje prava dioničara i pravo dioničara na informacije, Pravni vjesnik, Osijek, 2011.
6. Horak,H., Dumančić, K.(2011): Usklađivanje u području prava društava Republike Hrvatske s pravnom stečevinom EU, Pravo i porezi, br.5, 2011
7. Horak, H., Dumančić, K., Pecotić Kaufman, J.(2010)*: Uvod u europsko pravo društava*, Školska knjiga, Zagreb, 2010, p.
8. Nestor, S., Yasui, T., Guy, M.L.: The relevance of Corporate Governance to Euroasian transition Economies, p. 1.,
9. available at http://www.oecd.org/dataoecd/5/48/1930716.pdf
10. Veršić-Marušić, M.(2004): Zašto kodeks korporacijskog upravljanja?, Hrvatska pravna revija, 12/2004, p. 31-39.

Other:

1. EUROPE 2020 A strategy for smart, sustainable and inclusive growth /* COM/2010/2020 final, European Commission, 3. March 2010. EUROPE 2020 is a 10-year strategy proposed by the European Commission on 3 March 2010 for reviving the economy of the European Union.
2. OECD guidelines: State-Owned Enterprise Governance Reform An Inventory of Recent Change 2011. Available at http://www.oecd.org/dataoecd/43/4/48455108.pdf.
3. OECD Privatising State-Owned Enterprises: An overview of Policies and practices in OECD countries, 2003. Available at http://www.apec.org.au/docs/10_TP_PFI%204/Privatising%20SOEs.pdf;
4. The Companies Act (Official Gazette 111/93, 34/99, 121/99, 52/00, 118/03, 107/07, 146/08, 137/09).
5. The Court Register Act (Official Gazette 1/95, 57/96, 1/98, 30/99, 45/99, 54/05, 40/07, 91/10)
6. The Accounting Act (Official Gazette 109/07)
7. The Auditing Act (Official Gazette 146/05, 139/08)
8. The Capital Market Act (Official Gazette 88/08, 146/08, 74/09)
9. ZSE Rules, Zagreb, May 2011, available at http://www.zse.hr/UserDocsImages/legal/Pravila%202011_EN.pdf
10. The Corporate Governance Code available at http://www.hanfa.hr/index.php?ID=0&AKCIJA=230&LANG=ENG&vijestid=353

11. Directive 2004/109/EC of the European Parliament and of the Council of 15 December 2004 on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market and amending Directive 2001/34/EC, *OJ L 390, 31.12.2004, p. 38–57*

12. Commission Directive 2007/14/EC of 8 March 2007 laying down detailed rules for the implementation of certain provisions of Directive 2004/109/EC on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market, *OJ L 69, 9.3.2007, p. 27–36*

13. Directive 2001/34/EC of the European Parliament and of the Council of 28 May 2001 on the admission of securities to official stock exchange listing and on information to be published on those securities,

14. *OJ L 184, 6.7.2001, p. 1–66*

15. Directive 2003/71/EC of the European Parliament and of the Council of 4 November 2003 on the prospectus to be published when securities are offered to the public or admitted to trading and amending Directive 2001/34/EC, OJ L 345, 31.12.2003, p.64

16. Directive 2003/6/EC of the European Parliament and of the Council of 28 January 2003 on insider dealing and market manipulation (market abuse), *OJ L 96, 12.4.2003, p. 16–25*

17. Directive 2007/36/EC of the European Parliament and of the Council of 11 July 2007 on the exercise of certain rights of shareholders in listed companies, *OJ L 184, 14.7.2007, p. 17–24*

18. Directive 2008/11/EC of the European Parliament and of the Council of 11 March 2008 amending Directive 2003/71/EC on the prospectus to be published when securities are offered to the public or admitted to trading, as regards the implementing powers conferred on the Commission, *OJ L 76, 19.3.2008, p. 37–38*

19. Directive 2006/46/EC of the European Parliament and of the Council of 14 June 2006 amending Council Directives 78/660/EEC on the annual accounts of certain types of companies, 83/349/EEC on consolidated accounts, 86/635/EEC on the annual accounts and consolidated accounts of banks and other financial institutions and 91/674/EEC on the annual accounts and consolidated accounts of insurance undertakings (Text with EEA relevance) *OJ L 224, 16.8.2006, p. 1–7*

20. www.hanfa.hr.

21. Report on corporate governance, p.60, available at http://www.ripe.hanfa.hr/hr/publiciranje/izvjesca/

22. http://www.sabor.hr/Default.aspx?art=35628.

23. OECD Guidelines on corporate governance on Stat- Owned enterprises 2005, p.18

24. State-Owned Enterprise Governance reform: An inventory of recent change OECD 2011, p.7, available at http://www.oecd.org/dataoecd/43/4/48455108.pdf

25. Available at CIPE Center for International private enterprise, available at http://www.cipe.org/programs/corp_gov/index.php

Review
UDC 005.7:658.115>(497.5)

Vesna Bakran
Areta Čuturaš
Dina Tomšić

CORPORATE GOVERNANCE CHALLENGES IN STATE-OWNED COMPANIES IN CROATIA: HRVATSKA LUTRIJA/CROATIAN LOTTERY CASE

Abstract

The term 'corporate governance' stands for a set of relations between the company, its management and a wide variety of its stakeholders, defined as different interest groups that affect or may be affected by the company. A good corporate governance system is the basic postulate of sustainable economic growth and increase in economic efficiency and a guarantee for easier access to sources of capital. Unlike companies that are owned by private owners or entities, companies owned by the state are usually the ones that have to obey market and non-market rules and regulations, particularly the political ones. Additionally, they sometimes have to cope with the lack of knowledge and motivation because politically eligible instead of professional management is employed. On the other hand, there is a wide range of privileges that state-owned companies have and could rely on in fulfilling their economic and social mission and responsibility.

This article sheds light on the governance challenges in Croatian SOCs. By applying the corporate governance theoretical perspectives, especially the stakeholder approach, it aims to provide a framework for more effective governance practices of SOCs. The first part of the article presents the conditions under which corporate governance issues are relevant, highlighting the core governance differences of public enterprises: multiple and conflicting objectives, excessive political interference and sometimes opacity, i.e. lack of clear vision and directions. The second provides a theoretical framework customized for SOC practice. The third applies the analysis to the case of a Croatian SOC, the Croatian Lottery, suitable for explaining major changes in corporate governance induced by the processes of accession to EU, globalization and technological, legal, regulatory and market changes. These occurrences have strongly influenced the transformation of the Croatian Lottery governance model to one driven by the CSR principles with a special emphasis on the Responsible Gaming

Programme and adjustments required by the Anti-corruption Programme for Croatian SOCs. The case of the Croatian Lottery can lead to some useful conclusions that may be helpful as guidance to a policy applicable to such companies in general. We conclude by highlighting the importance of board member and managerial education, transparency and social responsibility as a driver of sustainable economic growth of SOCs.

INTRODUCTION

Corporate governance is a field dealing with the relations of governance structures within corporations determining the components of the governance system and the supervision of the corporation (Cadbury, 2002). According to Organisation for Economic Co-Operation and Development - OECD Principles of Corporate Governance, (2004) corporate governance involves a set of relationships between a company's management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performances are determined (OECD, 2004). Corporate governance can thus be defined as a kind of management of the management or meta management (Tipurić, ed., 2011:1).

It is a process in which corporations are responsible to legal rights and request of groups that have direct or indirect interest and influence – stakeholders. Tipurić and cooperates define corporate governance as "a system of controlling mechanisms through which all suppliers of crucial input should secure their return on investment into the corporation, without endangering its long-term survival and prosperity" (Tipurić, ed., 2008:6). This perspective emphasizes the main issues of corporate governance which refer to questions of power, authority and responsibility in accomplishing main companies' activities, taking into account that the basic purpose of the company is maximization of its profit-making capabilities (Blair, 1995:241).

If corporate governance is understood as a set of processes, habits, rules, laws, decisions, institutions and supervisory mechanisms used to influence the management, control and administration of the corporation, its implementation in the Croatian business environment can be shown at the example of the state-owned company Croatian Lottery.

CORPORATE GOVERNANCE AND SOC

The term corporation means the company form where the owners are not personally responsible for the duties or any other obligations a company assumes or can assume. Limited liability and the separation of the ownership function from the function of company resources administration (Berle and Means, 1932) are among the most important phenomena in economic history, which gave rise to the development of the corporate governance theory.

In the context of the Croatian legal framework, the term "corporation" corresponds to the term "dioničko društvo" (joint-stock company) and implies a legal subject, transferability of ownership, limited liability and no temporal limitations of business activities. This area is governed by the Companies Act of the Republic of Croatia, and also "društva s ograničenom odgovornošću" (limited liability companies), which is the legal form corresponding to SOC, are obliged to implement the Code of Corporate Governance of Companies whose Stocks or Shares are Owned by the Government of the Republic of Croatia. The Code prescribes the same basic framework and corporate governance bodies as in public joint-stock companies, which are the executive board, the supervisory board and the general assembly.

CORPORATE GOVERNANCE SYSTEMS

Depending on the prevailing influence in the company it is possible to identify two dominant systems of corporate governance: outsider control system and insider control system. In the outsider control system the market is the main corrective measure; this is in other words a system where the main control mechanisms arise from the outside and no single stakeholder has the possibility to actively supervise the management. On the other side, in a system that is controlled from the inside - insider control system - the market does not have such a significant role and s big level of active management control is present. Basic differences occur in issues of concentration, ownership identity and market liquidity of corporate control (Tipurić et al., 2007).

An outsider control system tends is to harmonize the interests of the company management and the interests of the investors, while an insider control system is symptomatic of a large number of relations defining the influence of individual interest groups on the setting of objectives and supervision of business policy implementation. The basis of both systems is redistribution of socio-economic power and balance in the decision-making process in the relation between the owner and the management. The characteristics of the corporate governance system are primarily determined by the legal system which is in place in the jurisdiction.

As the OECD Principles, although being non-obligatory, along with the affirmation of the Code of Corporate Governance as the basic document regulating the relationships and responsibilities in the corporate governance system, are directed at creating transparent condition for business operation and governance of corporations as well as for promotion of good practices, the relevant literature in this area has for some time been indicating the convergence of dominant systems to the construction of a uniform corporate governance model (Further reading in e.g. Hruška, D. (2005): Ownership Concentration and Corporate Governance in Croatia, Master Thesis, Faculty of Economy, Zagreb.).

Countries in transition, including Croatia, have generally adopted an insider control system characterised by high ownership concentration, whose defining characteristic is the existence of the corporation for fulfilment of the interests of groups surrounding it, not only of its owner.

CORPORATE GOVERNANCE MECHANISMS

Since corporate governance implies a set of different relationships between the management, the board, the shareholders and the stakeholders as well as the creation of conditions for defining objectives and the means to achieve them, an important part of this process are the means to gain control. Corporate governance mechanisms exist and work for this purpose. There are two basic mechanisms of control: external and internal. Internal control refers to the owners' direct monitoring and discipline of management work. External control occurs when other interest groups affect mechanisms of setting and achieving the company's goals.

Internal control mechanisms are: (1) board, (2) management compensations, (3) ownership concentration, (4) relationship to stakeholder groups, (5) corporate reporting, while external mechanisms include: (1) corporate control market, (2) legislative and regulatory framework, (3) protection of minority shareholders and (4) competition conditions (Tipurić, ed., 2008). Internal mechanisms and their interrelations are included in the company's Code of Corporate Governance. External impact is mainly observed from the national level perspective or from the perspective of belonging to a corporate governance system.

Croatia generally applies the insider control model, in which the influence of internal control mechanisms prevails. A characteristic of SOCs is that state ownership does not imply the existence of a corporate control market. Thus the possibility to supervise the success of the company by following the price of shares does not exist. Therefore, the supervisory boards, especially their structure, have the key role in the corporate governance of a SOC.

The supervisory and the executive boards are instruments used by the shareholders to influence the behaviour of the managers, and according to the manner of board organization we can differentiate between a monistic and a dual corporate governance model (Tipurić, ed., 2008). Croatian companies whose shares are owned by the government implement the dual corporate governance model, the usual practice being that the members of supervisory boards are not independent experts, but performers of executive power, such as ministers from the resort.

CORPORATE GOVERNANCE THEORIES

Corporate governance is to give answers to questions about who supervises the corporation and why (Kaen, 2003), how the corporation is managed and in whose interest (Blair, 1995) and in which way changes in corporate control positions occur (Tipurić, ed., 2011). Therefore, corporate governance can be seen as a means of finding the best way to discipline the management and it actually refers to institutionalized practices that result in manager's optimal performance.

The complexity of the issue of corporate governance has been recognized and shaped into three basic theoretic approaches to corporate governance: Agency, Stakeholder and Stewardship Theory. All three theories ponder the questions of the position and supervision of managers and their responsibility, behaviour and achievement corporate goals. Agency theory is based on establishing a contractual relationship between the stakeholders: the owner-principal and the manager-agent; the Stakeholder Theory looks at the wider responsibility relationship of the management to the synchronization of interaction of different stakeholder groups for the purpose of satisfying their interests and the interests of the company in the form of achieving business results. The Stewardship Theory arose as an alternative to the Agency Theory and is based on trust and a stewardship relation between the manager and the employee. It advocates balanced corporate governance in which managers resolve different stakeholders' conflicts of interest and represents an exceptionally important potential for achieving corporate sustainability (Podrug, 2010). Due to the specific position of SOC in relation to national economies, corporate sustainability will be dealt with in the next chapter.

As corporate governance models are increasingly used also by companies which are formally not present at the capital market (Tipurić, ed., 2008:22-23), including SOCs, development of consistent and complementary corporate governance systems, and a good corporate governance practice are the crucial issues for countries which want to stimulate investment in the private sector, attract foreign investments and create the context for higher rates of economical growth.

CHARACTERISTICS OF CORPORATE GOVERNANCE IN SOCS

It took some time for the corporate governance in transition countries to become an important regulatory, business and academic issue. Development of an adequate mechanism of corporate governance in transition countries differs from the same process in developed economies. The main difference is in the level of development of legal infrastructure and adequate financial institutions (Hruška, 2005).

Notwithstanding the privatisation waves during the past two decades, SOCs continue to constitute an important segment of the economy in many countries. State ownership is common in sectors or industries of strategic importance for the country or in important public services, so there is often a position of monopoly or quasi-monopoly of companies on the market (Wong, 2004). In cases of less vital industries the competition environment is intensified and there are increasingly many situations of the state selling shares to other minority shareholders. In such less concentrated ownership structures the state remains a blockholder and influences the management and business processes via the supervisory and the executive board.

But, SOCs have much to contend with when it comes to governance. Unlike private enterprises, which focus exclusively on profit maximisation, most SOCs pursue multiple – and conflicting – objectives. Because SOC are concentrated in the infrastructure (telecommunications, postal services utilities, and transportation) and energy (oil and gas) industries, their poor performance has significant ripple effects for the broader economy. In such circumstances, the efficacy and effectiveness of SOCs is of extreme importance. While SOCs may never entirely equal the performance of their private counterparts, a system of professional oversight that includes the checks and balances are the best recipe.

The performance of an SOC is significantly influenced by: diversity of the politic interests, lack of knowledge of the workforce and of motivational tools as well as often non-transparent business operations (e.g. Wong, 2004), which reemphasizes the key role and composition of supervisory boards as entities forming the goals and measures of business policy and directing and controlling the work of the executive board. The diversity of a company's opposite effectiveness objectives in relation to employment was noticed and examined by Menozzi et al. (2010) who analysed the effects of board composition on the behaviour and performance of Italian local public utilities. Their main findings indicate that politically connected directors, representing the state or the local municipality, dominate boards of directors in the Italian public utilities in the period under investigation, and that politically connected directors exert a positive and significant effect on employment, while they impact negatively on performance.

In Croatia the situation has significantly improved since the passing of the Code of Corporate Governance in companies whose shares or stocks are owned by the Republic of Croatia. The Government passing the Resolution on the obligation of its implementation as of September 2010 actually meant an improvement of the management system quality, emphasizing responsibility and ethics of owners, investors, regulatory bodies, but also of the wider public as its important elements.

However, practise confirms also the existence of direct unspecified yet present political interests which can significantly define, direct or undermine the efforts of the SOC executive board to achieve these objectives. The top management of SOCs are appointed by the Government, which came into the ownership position of a public company by the votes of the electorate. Thus the prevailing policy of the party or the coalition in power influences the setting of its objectives.

CORPORATE RESPONSIBILITY

The question of achieving business objectives by responsible social behaviour opens theoretical discussions on the nature of the connection of the company's economic and social purpose, i.e. the connection between the financial and non-financial goals and interests of the wider social community within which the company operates. Such dual setting of company goals needs to be optimally incorporated into the corporation's strategy in a way which would enable it to act in the interest of all relevant stakeholders. Contemporary business conditions caution that companies need to approach social, ecological and economical pressures strategically, in order for the company not to be isolated from society, its reputation not to be endangered, for the costs not to rise and finally for the value stock not to decrease, which is a new challenge for SOCs.

The primary responsibility of companies is financial effectiveness and lawful operations, but the companies in state ownership are governed by a wider perspective of responsibility. Ethical responsibility refers to conformance with norms and principles with maximum avoidance of negative outcomes, while social responsibility refers to a positive contribution to the society and the wider community. SOCs thus face two groups of responsibility simultaneously: Corporate Financial Responsibility (CFR) and Corporate Responsibility (CR). Corporate Responsibility (CR) is a concept in business research with roots in Business and Society literature (Andriof and Waddock, 2002). It is used as a broad term to describe the issues relating to the responsibilities of business. CR is conceptualized as the broad array of strategies and operating practices that a company develops in its efforts to deal with and create relationships with its numerous stakeholders and the natural environment.

CR is closely linked to other concepts in the Business and Society literature, most importantly the concept of Corporate Social Responsibility (CSR). While CR reflects the idea that responsibilities are integral to corporate actions, decisions, behaviours, and impacts, thus encompassing day-to-day operating practices and strategies of business as well as impacts on society and the environment (Andriof and Waddock, 2002), CSR, on the other hand, can thus usefully be seen as relating to the specific social, philanthropic and community focussed responsibilities of business: ethical and moral values and the adoption of best corporate practices including a better environmental protection than prescribed, better working conditions or support and promotion of the community's objectives and of projects of non-governmental organizations. The starting point of the concept is the Stakeholder Theory (Freeman, 1984) which assumes that the manager's role is in satisfying the interests of all components of the company which could influence its performance.

Since it is constantly within the focus of the media, the opposition and the wider social public, it is useful to consider the conceptualization of CR of SOCs from a stakeholder perspective. Taking into account how stakeholders make sense of CR would contribute to a better performance of the social and the economic role of SOCs. For these reasons, this paper reviews the key elements of Stakeholder Theory relevant to this approach.

STAKEHOLDER APPROACH AND SOC GOVERNANCE

The Stakeholder Theory developed from strategic management literature (Freeman, 1984). Its core theme is that businesses have obligations to a broader group of stakeholders than just shareholders. Freeman (1984) defines stakeholders as „any group or individual who can affect or is affected by the achievement of the organization's objective". The stakeholder approach to companies deals with issues of economic effectiveness but also with the relationship between the corporation and the society, i.e. the corporation's social responsibility, assuming the responsibility of profitability. It is thus in the centre of the discipline of *business and society*.

Stakeholder Theory has developed to view the firm as a nexus of relationships (Jones, 1995). This approach suggests that mutual trust between organizations and stakeholders are key drivers of long-term sustainable success. Donaldson and Preston (1995) suggest that work conducted with stakeholders could be viewed as descriptive, instrumental and normative. Another key tenant of stakeholder theory is that concepts, such as responsibility, are multifaceted and possess multiple criteria that can change over time (Harrison and Freeman, 1999). This is because concepts should reflect the different views and needs of stakeholders (Mitchell *et al.*, 1997). It is thus suggested that criteria should be established and measured in a process of consultation and engagement between organizations and stakeholders (Jones, 1995). In accordance with the aforementioned, SOC executive boards need to identify key stakeholders and their roles, as well as interests and unite and balance them, to be able to handle the company's both responsibilities as well as to cope with environmental shifts. The multi-stakeholder model of SOCs is depicted in Figure 1.

Figure 1: SOC relevant stakeholder groups

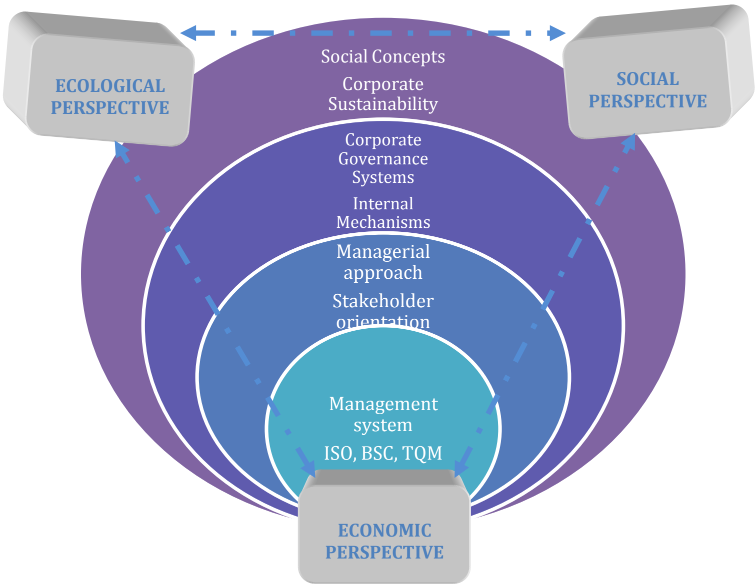
Source: adopted from Tipurić, ed. (2008): Korporativno upravljanje, Zagreb, Sinergija nakladništvo, p. 27

Figure 1 lists the stakeholders which influence or are influenced by SOC operations. According to the opinion of the author of this paper, a separate group consisting of employees, unions, customers, the state, society, along with moral and ethics of business operations are constituent parts of balancing operational governance. The other stakeholder groups are an important element of strategic governance of SOCs.

Besides the afore mentioned triad of objectives of SOC operations, more recent research in the field refer to the importance of implementation of sustainable development at the organizational level, so called corporate sustainability. This is a governance model determined by short-term and long-term economical, ecological and social performance of the company. It is the problem-solving process regarding pressures and different needs of those managing the company as opposed to the pressures of external forces, consequently reflected in gain or loss of corporate reputation, which is crucial for the understanding of corporate sustainability (Tipurić and Podrug, 2010; Steurer et al., 2005).

According the mentioned goals, responsibilities and concepts of SOC management, a theoretical framework can be created representing the starting point for an integrated corporate governance context which is symptomatic of SOCs. This is a combination of responsibility perspectives related to the position of the SOC which the executive board needs to balance in accordance with the requirements and interests of stakeholders having different relevance, depending on power ownership, urgency and legitimacy of stakeholders (Mitchell et al., 1997)

Figure 2: Corporate governance framework in SOC



ADVANTAGES OF SOCS

SOC business operations are often complex, but they have significant advantages as compared to the private sector. In the opinion of the author of this paper, the position of natural monopoly or quasi-monopoly ensures a stable and durable demand for the company's services, depriving its board of the necessity for constant use of a part of energy and resources on competition fight. In this context, the business operations of SOCs are less tumultuous. On the other hand, the relation to stakeholders can be drawn: SOC is a good and eligible customer and partner due to the stability of the system based on state ownership. Due to the force of their impact and often also due to their size, such companies can take a dominant position in relations to suppliers, competitors and other stakeholders.

State-owned companies generally obtain the consent and guarantee of the state for their large investment projects, and can in this way find financial sources easily and more favourably. Besides, state funds are often used to support a part of the operations or a customer category of SOC services, which means that these companies can also rely on this stability leverage in case of significant market disorder or change.

The executive and supervisory boards of SOCs often have equally large but more influential social capital than the private sector wherefrom they can extract the advantages of early obtaining information and their availability, but also of solving potential drawbacks and gaining privileged positions for a better market status in case the competition strengthens to an extent which would enable it to threaten the business operations of a company of state interest.

CORPORATE GOVERNANCE FRAMEWORK OF THE CROATIAN LOTTERY

The Croatian Lottery is established as a limited liability company for organizing and arranging games of chance and amusement games. The founder and only owner is the Republic of Croatia.

In its business operations, Croatian Lottery faces corporate governance problems familiar to SOCs throughout the world. In general, multiple and conflicting objectives, excessive political interference and lack of transparency are considered the main problems of SOCs all over the globe (Wong, S.C.Y., 2004), which might be also faced by Croatian SOCs. According to Wong, due to multiple and conflicting objectives SOCs do not only have commercial goals but they are also under obligation to serve social objectives such as providing jobs, serving public interest and providing basic necessities. This is different from the conditions faced by private companies which have a single goal i.e. profit maximization. Due to these multiple and conflicting tasks SOCs can be disadvantaged in competing with their private company counterparts for profits. Furthermore, excessive political interference and lack of transparency can lead to development of corruption, which is a crucial problem, especially in countries in transition. It is therefore necessary to build a system of corporate governance.

In addition, corporate governance in Croatian Lottery is significantly determined by its business activity of arranging games of chance, the EU accession process and changes in technology and the market.

CHARACTERISTICS OF THE BUSINESS ACTIVITY OF ORGANIZING GAMES OF CHANCE

The business activity of organizing games of chance significantly differs from other business activities due to the nature of games of chance itself. They are actually the *dream of luck* /dreamt when awake/, *chances for winning* /always present, but rarely comes true/ or *hope* /hope of a better, nicer and happier life/ (Čuturaš, Kozjak, 2008). It is therefore the position of state lottery organizations, i.e. those are owned or supervise by the state, that games of chance represent a special kind of service. The rule that competition is of eventual use for the customer as it results in optimum quality for smaller price does not apply to games of chance. In their case increased competition does not lead to a decrease of product price and an improvement of quality, but to an increase of the payout percentage from the receipts. A higher prize fund seems at the first glance to be of advantage for the players, but it is also an important risk factor of the game for development of addictive behaviour in players. The consequences of addictive behaviour such as dysfunctional families, treatment of addicts, their labour and social incapability are destructive not only for the individual and his/her family but also for the wider social community. State lotteries consider it therefore necessary to organize games of chance in a socially responsible manner, to ensure satisfaction of the need to play in a legal and controlled way, but retaining a sustainable growth of the game turnover and of the assets collected for socially useful activities, without simultaneously endangering, but even protecting vulnerable groups such as minors, potential addicts and the economically disadvantaged.

The key characteristic of all state lotteries, including Croatian Lottery, is their obligation, either by law or by a concession contract, to assign funds to socially useful activities such as sports, culture, education etc. The manner of distribution and assignment of funds differ from state to state and are conditioned by the priorities of the individual state. Two models prevail:

1. lottery pays the funds (duties, concession fees, profit) into the state budget wherefrom they are assigned and forwarded by the competent bodies to end users according to regulations;
2. lottery forwards the funds directly to their users.

In Croatia the first model is applicable, so Croatian Lottery fees and the profit are a constituent part of the budget of the Republic of Croatia, while 50% of these funds are directed to users under the Decree on the Criteria for Determining the Users and the Manner of Distribution of a Part of the Profit from Games of Chance. The distribution criteria are determined in accordance with national strategies and programmes for satisfying the public needs in appropriate business activities and pursuant to programmes for support of civil society development, and are shown by individual programme activities portion in the total part of the revenue of games of chance.

EU ACCESSION PROCESS

The delivery of corporate governance in SOCs in Croatia is result of outsider's ordain, which means that Croatia adopted EU corporate governance within the process of harmonization and accession to the European Union. The two most significant documents from this area are the Code of Corporate Governance for Companies Whose Shares or Stocks are Owned by the Republic of Croatia (Official Gazette / “Narodne novine” No. 112/2010) and the

Anticorruption Programme for Mostly State-Owned Companies (AKP) for the Period 2010-2012 (27th session of the Government of the Republic of Croatia of 26th November 2009). Objectives/measures from both documents have been implemented into corporate governance practice in Croatian Lottery to a significant extent. The Anticorruption Programme measures have been incorporated into the Croatian Lottery Action Plan for Implementing the AKP Measures and as of September 30th 2011 almost 90% of the measures and activities have been implemented. The activities conducted in Croatian Lottery were presented as an example of good practice at the Conference "Results, Experience and Challenges in AKP Implementation for Mostly State-Owned Companies for the Period 2010-2012" on 29th April 2011.

In addition, Croatian Lottery actively observes the events at the European market of games of chance. The business activity of organizing games of chance has not been harmonized at EU-level and there is no community acquits which would uniformly determine the preconditions for organizing games of chance for all EU member states, which they would be obliged to incorporate into their national legislations. Due to their influence on the social order and the health of citizens and each country's right to protect its citizens, the EU granted each individual country the jurisdiction to regulate games of chance in its national territory respecting the principles of vindication and proportionality.

In addition to actively following the situation at the European market for games of chance, Croatian Lottery is also actively involved into the activities of the association of European and global lottery organizations and is one of the signatories of the European Lottery Responsible Gaming Standard. The aim of this Standard is to demonstrate a consistently high level of responsibility across all lotteries such that all reasonable steps are being taken to deploy a consistent Responsible Gaming approach. Requirements in 10 areas of the Standard need to be met: Research, Employee training, Sales agents' programmes, Game design, Remote gaming channels, Advertising and marketing, Treatment referral, Player education, Stakeholder engagement and Reporting, measurement & certification. Croatian Lottery has implemented the Requirements of the Standard into its business operations and is expected to gain the Certificate of Provider of Responsible Gaming Services until the end of 2011.

TECHNOLOGY AND MARKET CHANGES

Trends on the gaming market faced by Croatian Lottery are the same ones faced by other lottery organizations in Europe. The number of different player segments is increasing, with changes in behaviour, habits, expectations and occurrence of new needs. Fast changes in development of technologies are only one of the new challenges faced by European lotteries. Direct competition and overlapping of the services portfolio with other companies which organize games of chance are becoming increasingly important, as are indirect competition in form of different prize-winning games, which partially satisfy the gaming need, and the growing offer in the amusement and free time segment.

Places of sale as traditional distribution channels are becoming less and less attractive, while channels related to fast-growing technologies (internet, mobile technology, interactive TV…) are gaining importance. The number of lotteries offering besides lottery games via internet and mobile phones also new games specially created for these media. The younger population asks for dynamic, fast games, they join the game impulsively and are not used to purposefully going to places of sale; thus lottery products are increasingly offered in larges shops with consumer goods, usually at the places of payment – the cash-desks, with use of technologies enabling fast, sometimes self-service play of games.

At the gambling market in the Republic of Croatia 81 gambling entrepreneurs operated actively and legally during 2010 (Croatian Lottery Business Operations Report for 2010). Croatian Lottery organizes games in all four categories of games of chance permitted by the Act on Games of Chance. Lottery games (Croatian Lottery has a monopole), Betting games, Casino games and Slot machine games. However, the market share of Croatian Lottery in the total gambling market in the Republic of Croatia is 20%. The most important game of chance in 2010 is betting with a portion of 88%. Although this game is present at the gambling market in the Republic of Croatia since 2000, Croatian Lottery has been organizing it since 2004 and Croatian Lottery's share in this game at the gambling market is 11%.

Since Croatian Lottery is a limited liability company it is not obliged to comply with the prescribed corporate governance rules in Croatia, but due to the mentioned reasons Croatian Lottery implements them in its practice to a great extent.

CORPORATE GOVERNANCE MECHANISMS IN THE CROATIAN LOTTERY

The main challenges and mechanisms of corporate governance in Croatian Lottery have been determined by the business activity of organizing games of chance, the EU accession process, technological and market changes as well as full state ownership.

The Croatian Lottery, as most companies in Croatia, belongs to the insider control model, whose characteristics are high ownership concentration and prevailing influence of internal governance mechanisms. Good corporate governance depends on balanced relations between diverse internal and external mechanisms used to ensure effectiveness of management and to assist in solving problems and conflicts in corporate structures.

INTERNAL MECHANISMS OF CORPORATE GOVERNANCE

There are five internal governance mechanisms established and applied in Croatian Lottery: ownership concentration, supervisory board, management compensations, corporate reporting and relationship to stakeholders.

1. Ownership concentration

Ownership concentration is one of the most important governance mechanisms symptomatic of countries which do not have a developed capital market. It is assumed that large ownership concentration enables efficient supervision of management by the owners with low agency costs. However, this mechanism often places minority owners into a dependent position in relation to block owners (Beiner et al. 2003, Shleifer and Vishny, 1997) and the expropriation of their rights. Large investors act through supervisory boards. In case that they are in the position to appoint the majority of supervisory board members they can appoint and dismiss the management, initiate or block the passing of decision et al. As supervisory boards are responsible for the implementation of the corporate governance system, the owners are responsible for appointing qualified and efficient supervisory board members (Cadbury, 1992).

The state performs its role of Croatian Lottery owner via the organs of the company: the Assembly, the Supervisory Board and the Board. The state is represented in the Assembly by three ministers. Appointment of Supervisory Board members was carried out by the Assembly after the conduct of a public tender pursuant to the Decree on the Manner of Conducting Public Tenders and the Conditions for Members of Supervisory and Executive Boards of Companies Whose Shares or Stocks are Owned by the Republic of Croatia. By Assembly decision the Head of the Board was appointed. The Supervisory Board concluded an Employment Contract with the Head of the Board in which the mutual rights and obligations of the Company and the head of the Board are established.

Pursuant to the OECD Principles of Corporate Governance the state as owner is not included into everyday management and enables the company to have total business independence. However, the company also sets its objectives independently, and in the opinion of the authors of this paper the state as owner should develop and publish its ownership policy, set the strategic goals and priorities of Croatian Lottery. In this way the state would provide for clear understanding of its goals by all stakeholders, the company itself, the market and the wider public.

Also, the state should separate its ownership from the legislative function, since these roles differ significantly. State as active owner should be focused on efficient assertion of its ownership rights, i.e. in this role, the state should act as any shareholder who needs to protect its ownership and optimise its value. On the other hand, in its legislative function the state should provide for equal market space for Croatian Lottery as state-owned company as well as for other gaming operators from the private sector. In the present situation, when these two roles of the state are performed by one body, the Bureau for Games of Chance at the Ministry of Finance, neither of these roles is transparent.

2. Supervisory Board

Supervisory boards are the key element of the corporate governance system as they set the policies and strategies determining the future of the corporation and are in the closest relationship to the management. For all reasons stated the issue of the role and structure of supervisory boards is the key issue in the discussion on corporate control (Tipurić, 2006).

The dual governance model is symptomatic of Croatia, and it is also present in Croatian Lottery. The Croatian Lottery Supervisory Board consists of five members. Four Croatian Lottery Supervisory Board members were appointed by the Assembly after a public tender had been conducted pursuant to Decree on the Manner of Conducting Public Tenders and the Conditions for Members of Supervisory and Executive Boards of Companies Whose Shares or Stocks are Owned by the Republic of Croatia. The fifth member of the Supervisory Board was appointed by the Croatian Lottery Works Council.

The Croatian Lottery Supervisory Board does not differ in the number of members from other Croatian companies, which on the average have five supervisory board members (Dropulić Ružić, 2011). The members of the Supervisory Board are professional younger persons with very high education (three members have a master or doctor degree).

In the opinion of the author of this paper, the manner of selecting the members of the supervisory board, their experience, education and structure can significantly contribute to the quality of corporate governance in Croatian Lottery. Regarding transparency of work of the Supervisory Board, the Rules of Procedure are published at the web side of the Company, but the CVs of the Supervisory Board members should also be published, along with summary reports from meetings; a member compensation policy, relating the compensations to the achievement of Company goals, should also be adopted and published. Compensations to Supervisory Board members should among other also contribute to their independence. An appropriate compensation for work is the basis for the independence of Supervisory Board members since persons who receive appropriate compensation for their work in that way achieve independence and such appropriate compensation provides for their independence and autonomy in their work for the Company (Horak, Dumančić, 2009).

It would be useful to draft a programme for introduction of future new members of the Supervisory Board into the operations of the company and the activities of the Supervisory Board since generally only few Supervisory Boards members have previous experience and knowledge on the operations of the company. In addition, measures for improvement of the work of the Supervisory Board should be proposed and continual professional training should be carried out.

Pursuant to AKP Guidelines the Croatian Lottery Supervisory Board established its subdivision for audit, the Audit Board. The members of the Audit Board are the members of the Supervisory Board plus an external collaborator, an audit expert. The Audit Board was established for the purpose of better surveillance of financial reporting, accountancy activities and support to establishing a good and competent internal audit of the Company. The rules and the scope of activities of the Audit Board are defined in the Rules of Procedure of the Audit Board.

Important corporate governance instrument in Croatian Lottery are independent external auditors. Their basic function is to assert that financial reports adequately convey the actual state of the entire Company.

3. Management Compensations

Management compensations along with bonuses represent one of internal governance instruments which are used most often and which are generally assumed to be a good motivational instrument used to harmonize the owner's interests (profit maximisation) with the management's interests.

Management compensations are in focus of scientist from the field of corporate governance, management, organization and human resources management. Different combinations of direct and indirect compensations are used in different industries.

The income level of members of the board is usually defined in negotiations with the particular managers and in accordance with the particular conditions. The most important reward criteria are achievement of plans, fulfilment of strategic goals, amount of the profit earned and success in the business field for which the individual member of the board is responsible. The quality of reporting to the supervisory board, the quality of inner control and loyalty to the company are less important as criteria.

The Croatian Lottery Board consists of one member, the Head of the Board. Mutual rights and obligations between the Company and the Head of the Board are regulated by the Employment Contract. The provisions of that contract establish the compensations consisting of the basic salary and the reward. The reward is the variable part of the salary which is to be paid once per year, and the criterion for determining its amount is the amount of profit earned. However, due to cost-saving methods introduced by the owner in the past three years, the salary of the Head of the Board is determined by a special Decision of the Government of the Republic of Croatia and is regulated by an annex to the Employment Contract, so the reward bound to profit earned is not paid.

The rewards of board members and of executive directors, their structure and the methods for determining them are a constituent part of the Code of Corporate Governance of Companies Whose Shares or Stocks are Owned by the Republic of Croatia (Official Gazette / Narodne novine No. 112/2010), but these provisions are currently not being applied. This shall surely impact the quality of corporate governance in these companies.

According to Babić the business environment in transition countries is lacking the necessary elements that constitute a competitive environment and favours older, large and dominant firms, and discourages entrepreneurship and the emergence of new companies. Unstable macroeconomic conditions create great uncertainty and a shorter time period of the company under those conditions. In these unpredictable economic circumstances, managers see their positions as temporary and uncertain, leading to problems that maximize their own profits rather than maximizing the profits of enterprises (Babić, 2003:11).

The above mentioned gives rise to the conclusion that in this field there is place for improvement. It can be concluded that an increase of the variable part of the compensation is possible for the purpose of a better motivation of board members for achieving business objectives.

In addition, the knowledge, skills and experience of board members are important for the quality of their work and successful operations. Therefore, the Company should in accordance with its needs and possibilities encourage the constant further education and training of board members, continuous revision and improvement of their knowledge and capabilities. The Croatian Lottery Head of the Board has extensive experience of working within Croatian Lottery on different positions and continually improves her education in special trainings in the field of games of chance and in specialist educations in the field of governance (she finished postgraduate specialist studies at the Faculty of Economics in Zagreb with education programme "Corporate Governance for Members of Supervisory and Executive Boards").

4. Corporate reporting

Corporate reporting means publishing information and financial transparency. These activities are important for existing and future investors. We differentiate obligatory and voluntary reporting and in this segment the channels for distribution and delivery of information and the content of this information itself are important. According to modern conceptual frameworks, financial reports are primarily oriented to satisfying information needs of external users, investors and creditors. (Pervan, 2008)

In addition to its actions, conduct and communication, companies influence the opinion of themselves and thereby their reputation by information transparency in the relationships with their stakeholders, i.e. by reporting (e.g. Zabala et al., 2005). Therefore, business annual or periodic reports of companies have been extending in the recent years beyond financial and investment results to environmental reports, reports on social responsibility and other value profiles and contributions of the company intended for different stakeholders.

Corporate reporting in Croatian Lottery is prescribed by: the Accounting Act, the Act on Games of Chance, the measures of the Anticorruption Programme for Companies in Majority State Ownership for the Period 2010-2012 (27th meeting of the Government of the Republic of Croatia of 26th November 2009).

At its web pages Croatian Lottery provided access to all relevant information. At the web the following are published: mission, vision, development plan, annual business plan, data on the members of the Board, the Supervisory Board and the Assembly, organizational scheme with the names of directors responsible for particular areas, annual business reports, the report of the independent external auditor, the report on socially responsible operations.

Information related to employment processes are also published at the web pages, along with information on public procurement, implementation of the measures of the Anticorruption Programme, responsible organization of games of chance and sponsorships and donations. The names and contact details of persons who can be contacted for additional information or to report irregularities relating to business operations and ethics are also published.

5. Relations with stakeholder groups

Croatian Lottery is aware of the importance of relations with all stakeholder groups and has thus established interactive, formal and informal communication with all of them. Such communication enables asking questions, expressing opinions and discussion of topics relevant to them. Croatian Lottery recognized the following groups as its key stakeholder groups: players, employees, fund users, experts in prevention and treatment of addiction to games of chance, rest of the professional public, social partners, regulators and media.

EXTERNAL MECHANISMS OF CORPORATE GOVERNANCE

1. Legal and regulatory framework

The legal and regulatory framework is of special significance for corporate governance of all companies. Among the leading legal rules related to governance, surveillance and control in Croatian Lottery it is necessary to stress the Companies Act (official gazette Narodne novine No. 107/2007), Code of Corporate Governance of Companies Whose Shares or Stocks Are Owned by the Republic of Croatia (official gazette Narodne novine No. 112/2010), Anticorruption Programme for Companies in Majority State Ownership for the Period 2010-

2012 (27th meeting of the Government of the Republic of Croatia of 26th November 2009) and the Act on Games of Chance.

Code of Corporate Governance of Companies Whose Shares or Stocks Are Owned by the Republic of Croatia states that the aim of passing the document was "establishing, maintaining and further improvement of high standards of corporate governance and transparency in business operations of companies in which the Republic of Croatia has a majority or prevailing share for the purpose of efficient and responsible management of public capital and business activities of special social interest in the function of development of Croatian economy and in the best interest of the citizens as tax payers and users of public goods and of all other stakeholder groups with whom they get into business and legal contact." It further states that the basic principles of the Code are: legality; transparency and publicity of business operations; segregation – clearly established procedures for the work of supervisory boards, the board and other bodies and the structure of the decision-making bodies; prevention of conflict of interest;, efficient internal control; strengthening of personal responsibility and responsible business operations.

The Government of the Republic of Croatia passed the Anticorruption Programme for Companies in Majority State Ownership for the Period 2010-2012 on 26th November 2009 with the goal of enforcing integrity, responsibility and transparency in the work of companies and the creation of preconditions for prevention of corruption at all levels. The main focus of the Programme is on five areas:

- improvement of public sector services with stress on enforcement of responsibility for successful fulfilment of tasks and promotion of building integrity and transparency,
- conducting business activities in an ethical, economical, effective and efficient way,
- conducting business in conformance with laws, regulations, policies, plans and procedures,
- protection of property and other resources from loss caused by bad governance, unjustifiable spending and use and from irregularities and fraud,
- timely financial reporting and monitoring of business results.

The function of the Code of Business Ethics is to guide the company's organs and employees in running the company. Furthermore, the code regulates conflicts of interests, gifts and donations, compliance with laws and regulations, confidentiality of information, and reporting of unethical behaviour.

Croatian Lottery incorporated ethics in its organizational values and organizational culture as an important goal of corporate governance. Adopting a Code of Ethics, appointing an ethics commissioner and passing educational plans is defined in the AKP. Croatian Lottery passed the code of ethics (Code of Conduct) in 2010. This Code prescribes compliance with legal and internal acts, compliance with general principles of ethical behaviour in the working environment via (1) development (promoting sustainable business practice; increase of value and profitability; innovativeness and creativity and social responsibility), (2) reputation and quality assurance, (3) relationship towards work and cooperates (integrity, promoting free market economy, cooperation with third parties, cooperation with social partners, cooperation with employees, cooperation with business partners, accepting differences), (4) responsibility (prescribing responsibility of managers and employees), (5) health and environmental protection. An important part of the Code is naming unacceptable forms of behaviour: (1) conflict of interests, (2) accepting or giving gifts or services. The Code emphasizes appliance of behaviour relating to protection of property and confidential information and the way of submitting complaints on behaviour opposed to the ones prescribed by the Code and sanctioning violations of the Code.

The Act on Games of Chance is a uniform regulation which regulates the organization of games of chance in the territory of the Republic of Croatia. Pursuant to its provisions a fee on organization of games of chance is paid, which is collected as income of the state budget. The Act on Games of Chance regulates the right to organize games of chance and the system and preconditions for organizing games of chance, the status of Croatian Lottery, distribution of profits from games of chance, preconditions for giving concessions, technical and other conditions for organizing games of chance in casinos, slot machine clubs and betting shops, manner of payment and amount of the fee for organizing games of chance, reporting obligation, system and conditions for organizing prize-winning games, games of chance abroad and surveillance of organization of games of chance and prize-winning games.

2. Corporate control market

External corporate governance mechanisms refer primarily to the corporate control market, which effectively monitors the management of the company, so that companies which are not efficient enough, i.e. whose management does not operate effectively, can be taken over by more effective companies very quickly. One of the most efficient mechanisms of corporate control is also the manager market, forcing the management to operate effectively as they could always be replaced. Since Croatian Lottery has a closed system, this role is performed by the Supervisory Board of the Company.

CONCLUSION

Increased scrutiny by the public, press and non-governmental organizations puts SOC under the pressure of economic performance and expanded responsibility simultaneously. To avoid inappropriate interference, SOCs must be insulated from political and bureaucratic pressures.

In cases where the government sets multiple objectives, they should be ranked by priority, with clear guidelines about how to make trade-offs among secondary objectives. While the government, as the shareholder of SOCs, has a legitimate right to influence the SOCs within its portfolio, its sphere of influence should be limited. Appropriate roles for the government include setting objectives and performance targets, appointing directors, monitoring the performance of the enterprise and its board, and stepping in when things go wrong. Aside from intervention rights, which should be clearly articulated and publicly disclosed, the remaining authority should reside in a professional board and management.

This places the importance of a good corporate governance practice and transparency that raises SOC accountability into focus. Access to information provides a basis for government accountability and raises the barriers against opportunism of managers. Information should be provided not only on corporation's performance but also on its objectives, especially non-commercial, social and environmental goals.

In order to conform with divergent forces of SOC environment, as well as to ongoing changes in business ecosystem, we proposed an integrated model of corporate governance perspectives and management systems that we find suitable for SOCs. Based on experience and corporate governance mechanisms, presented in case of Croatian Lottery, we hope to contribute to the development of a good corporate practice in Croatian SOCs.

References

1. Andriof, J., Waddock, S. (2002): Unfolding stakeholder engagement. In Andriof, J., Waddock, S., Husted, B., Rahman, S.S.(Eds.), Unfolding Stakeholder Thinking: Theory, Responsibility and Engagement: 19–42. Sheffield: Greenleaf
2. Berle, A., Means, G. (1932): The Modern Corporation and Private Property, New York
3. Blair, M. M. (1995): Ownership and Control, Washington, D.C.: Brookings Institution
4. Cadbury, A. (1992): Committee on the Financial Aspects of Corporate Governance - Report, Gee Publishing
5. Clarkson, M.B.E. (1995): A Stakeholder Framework for Analyzing and Evaluating Corporate Social Performance. The Academy of Management Review, 20(1):92-117
6. Čuturaš, A., Kozjak, B. (2010), Business Ethics and Gambling, 5th International Conference "An Enterprise Odyssey: From Crisis to Prosperity - Challenges for Government and Business“, University of Zagreb, Faculty of Economics & Business, Opatija, Croatia
7. Donaldson, T., Preston, L. E.(1995): The stakeholder theory of the corporation: Concepts, evidence, and implications, Academy of Management Review, 20(1):65–91
8. Freeman, R. E. (1984). Strategic management: A stakeholder approach, Boston, MA, Pitman Press
9. Freeman, R. E., Wicks, A.C., Parmar, B. (2004). Stakeholder Theory and “The Corporate Objective Revisited”. Organization Science, 15(3):364-369
10. Harrison, J. S., Freeman, R. E.(1999): Stakeholders, social responsibility, and performance: Empirical evidence and theoretical perspectives. Academy of Management Journal, 42(5):479–485
11. Horak, H., Dumančić, K. (2009): Neovisnost i nagrađivanje članova nadzornih odbora i neizvršnih direktora, Zbornik radova Pravnog fakulteta u Splitu
12. Horak, H., Dumančić, K., Pecotić Kaufman, J. (2010): Uvod u europsko pravo društva, Školska knjiga, Zagreb
13. Hruška, D. (2005): Vlasnička koncentracija i korporativno upravljanje u Hrvatskoj, Magistarski rad, Ekonomski Fakultet Zagreb
14. Jones, T. (1995): Instrumental stakeholder theory: A synthesis of ethics and economics. Academy of Management Review, 20(2):404–437
15. Kaen, F. R. (2003): A Blueprint for Corporate Governance: Strategy, Accountability and Preservation Shareholder Value. New York: American Management Asociation, str.1. u Tipurić, ur., (2008) str. 6.
16. Menozzi, A., Gutiérrez Urtiaga, M., Vannon, D. (2010): Board Composition, Political Connections and Performance in State-Owned Enterprises
17. Mitchell, R. K., Agle, B. R., Wood, D. J. (1997): Toward a theory of stakeholder identification and salience: Defining the principle of who and what really counts. Academy of Management Review, 22(4):853–886
18. Organization for Economic Co-Operation And Development (2004): OECD Principles of Corporate Governance, OECD Publications, Paris, available at www.oecd.org
19. Podrug, N. (2010): Odnosi uslužnosti između menadžerskih razina u velikim hrvatskim poduzećima, doktorska disertacija, Ekonomski fakultet Sveučilišta u Zagrebu
20. Stiglitz, E.J. (1999): Quis custodiet ipsos custodes?, Corporate governance failures in the transition, Annual bank conference on development economics-Europe, Pariz

21. Steurer, R., Langer, M.E., Konrad, A., Martinuzzi, A. (2005): Corporations, Stakeholders and Sustainable Development I: A Theoretical Exploration of Business–Society Relations. Journal of Business Ethics, 61:263–281

22. Tipurić, D., Hruška, D., Sadžak, M., Prester, J. (2004): Zaposleničko dioničarstvo u tranzicijskim zemljama, u Tipurić, D. ur.(2004): ESOP i hrvatsko poduzeće, Sinergija, Zagreb

23. Tipurić, D., Hruška, D., Aleksić, A. (2007): Corporate Governance and ownership concentration in Croatia, The Business Review, Cambridge, 7(1):207-212.

24. Tipurić, D. (ur.)(2008): Korporativno upravljanje, Sinergija, Zagreb

25. Tipurić, D., Podrug, N. (2010) Korporativna održivost velikih hrvatskih poduzeća, Zbornik Ekonomskog fakulteta u Sarajevu, str. 332-346. (ISSN: 1986-5473) (indeksirano u bibliografskoj bazi EBSCO)

26. Tipurić, D. (ur.)(2011): Promjene vrhovnog menadžmenta i korporativno upravljanje, Sinergija, Zagreb

27. Wong, S.C.Y. (2004): Improving Corporate Governance in SOEs: An Integrated Approach. Corporate Governance International, June, 7(2):1-15

28. Zabala, I., Panadero, G., Gallardo, L. M., Amate, C. M., Sánchez-Galindo, M., Tena, I., Villalba, I. (2005): Corporate Reputation in Professional Service Firms: Reputation Management Based on Intellectual Capital Management. Corporate Reputation Review, 8(1):59-71

Professional Paper
UDC 347.999(497.5)

Mario Vukelić

THE ROLE OF COMMERCIAL COURTS IN CROATIAN ECCONOMY

Abstract

The Croatian Constitution guarantees the autonomy and independence of judicial power which is exercised by courts established by law.
In Croatia, judicial power is vested in regular and specialized courts. Among others, specialized courts are commercial courts and the High Commercial Court of the Republic of Croatia. The Supreme Court of the Republic of Croatia is the highest judicial instance. The Constitutional Court of the Republic Croatia is a separate body. Croatian legislation is aligned with law of the European Union (acquis communautaire). The greatest challenge of Croatian judiciary is the resolution of the extensive backlog of cases as well as lengthy of proceedings.
All commercial courts are hierarchical and are organized in two instances. At first instance there are 7 commercial courts. There is one High Commercial Court of the Republic of Croatia established for the whole territory of the Republic of Croatia.
Generally, the commercial courts are competent in disputes between legal persons, bankruptcy proceedings intellectual property disputes, register of companies, maritime and air law disputes, status of companies, unfair market competition, monopolistic agreements and pursue other activities provided for by law. Commercial courts also conduct proceedings for the recognition and enforcement of foreign judicial decisions and arbitral awards in commercial cases, and carry out tasks relating to international judicial assistance in presenting evidence in commercial cases.
As to the law that commercial courts apply in the proceedings, there should be pointed out the Civil Obligations Act, the Companies Act, and the Bankruptcy Act. Foreign investment in Croatia is widely encouraged. The laws are the same for Croatian investors as for foreign investors and there is no discriminatory treatment. Companies in Croatia

generally possess the same features as in other legal systems. Court registers through website hitro.hr allows for the establishment through the Internet within 24 hours of a limited liability company. The Bankruptcy Act addresses the liquidation and reorganization of a debtor and it is consistent with market-based economy.
The Croatian business community and the overloaded judiciary recognized the need for change. Fast and efficient resolution of unresolved cases should be seen as a key priority within the commercial judiciary. The way to render Croatian commercial courts more able to address the growing problems brought about by the economic crisis is to introduce changes within the legal framework and by reinforcing the discipline within the overall economic system.
This can be done by thinking out of the box and introducing new ideas, free from the existing legal stereotypes.

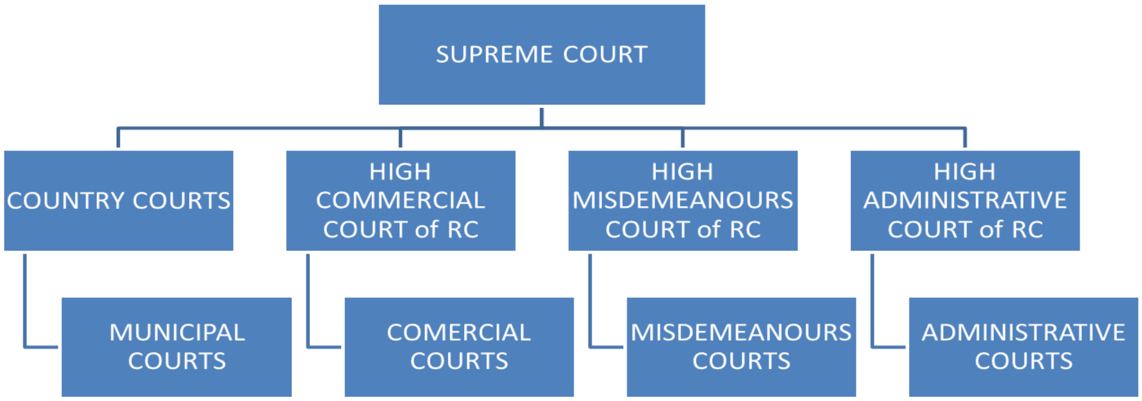
ABOUT THE COURTS IN CROATIA IN GENERAL

The Croatian Constitution guarantees the autonomy and independence of judicial power which is exercised by courts established by law.

In Croatia, judicial power is vested in regular and specialized courts. Regular courts are municipal courts, county courts and the Supreme Court of the Republic of Croatia. Specialized courts are misdemeanors courts, commercial courts, administrative courts, the High Misdemeanors Court of the Republic of Croatia, the High Commercial Court of the Republic of Croatia, and the High Administrative Court of the Republic of Croatia. There are in total 124 courts in Croatia and the Constitutional Court of the Republic Croatia as a separate body.

The misdemeanors courts, municipal courts and commercial courts are the courts of the first instance. The High Commercial Court, as well as the county courts, is the court of the second instance. From January 2012 administrative procedures will be conducted by four administrative courts of the first instance and by the High Administrative Court of the Republic of Croatia in the second instance.

The Supreme Court of the Republic of Croatia, as a highest judicial instance, ensures the uniform application of law and equal position of citizens under the law.



The Constitutional Court of the Republic Croatia, among the others, observes the realization of constitutionality and legality and notifies the Croatian Parliament about instances of unconstitutionality and illegality observed.

The greatest challenge of Croatian judiciary is the resolution of the extensive backlog of cases as well as lengthy of proceedings. These have resulted in many cases being brought before the European Court of Human Rights.

In general, it is the case that the public is made to believe that courts failure due to insufficient work conditions are courts failure as such. Media is not very interested in authentic opinions and reasons.

Although numerous measures have been taken, and judges are and should more improved performance of judicial duty, reduction of the number of unresolved cases is key to improve public perception of courts.

Basically, it means increasing number of judges, which lead to increasing of court budget. And that is definitely not popular in present recession.

In order to increase the efficiency of the justice system, Croatia is devoting special attention to reducing the number of unresolved court cases. The rate of resolution of current unresolved court cases is higher than the inflow of new cases, which has created conditions for the continuous reduction of the backlog.

Currently, Croatia is directing its efforts towards the group of so-called old cases, i.e. cases that have been pending for more than three years.

In Croatia, a system is in place for the protection of the right to a trial within a reasonable time. Acting further to a request of the parties for a trial within a reasonable time, higher courts can accelerate court proceedings conducted by lower courts by setting a term within which the court conducting the proceedings must issue a decision and by defining suitable compensation for the infringed right.

A three-month deadline has been set within which the higher court must decide upon the request.

SPECIFICATION OF COURT MANAGEMENT SYSTEM

Money needed for the operation of courts (budget of court) with funds needed for technical equipment and office space in accordance with defined standards, shall be financed from the Budget of the Republic of Croatia.

Costs for the operation of courts include the funds needed for the regular operation of courts (salaries of judges, judicial officials and employees, utilities and supplies, replacement costs and costs of depreciation of equipment and buildings) and money for special purposes.

The funds shall be allocated in an amount which will ensure the regular financing of the entire operation of courts on the basis of a previously obtained opinion of the Convention of the Supreme Court of the Republic of Croatia.

The court president shall, within the time specified in the Budget Act, submit to the Ministry of Justice a proposed budget for the work of the court in the next fiscal year.

Based on the budget proposed by the court president, the Ministry of Justice shall, together with the court president, determine the court budget necessary for the work of the court in the next fiscal year based on the needs and achieved results of the court.

Presidents of the courts decide about engagement and allocation of particular persons to positions of qualified administrative court staff.

Judges shall have the right to a salary established for such a position according to the Courts Act and The Act on the Salaries of Judges.

APPOINTMENT OF JUDGES IN CROATIA

Croatia has set a new legislative framework for the system of recruitment, training, appointment and promotion of judicial officials.

According to the provisions of the Judicial Academy Act, a key step in the career of judicial officials who are appointed for the first time to judicial office is enrolment in the State School for Judicial Officials as a separate unit of the Judicial Academy.

State Judiciary Council is the only body vested with the authority to appoint, relieve of duty and decide on the disciplinary liability of judges. The State Judiciary Council consists of 11 members (7 judges, 2 university professors of legal science and 2 representatives in the Croatian Parliament).

Decisions on appointments and promotions adopted by the State Judiciary Council are based on objective criteria.

Croatia has legislative framework for the system of recruitment, training, appointment and promotion of judicial officials.

Eligible for appointment as a judge is, in general, a person who is citizen of the Republic of Croatia, has finished the Law School and passed the Bar exam and has professional experience that is required by the Act of the State Judiciary Council depending on the type of the court person is applying for.

Judges are appointed on the first occasion for a five-year period, after which they are assessed and undergo the procedure of permanent appointment.

Councils of judges, body composed solely of judges elected by the judges of individual courts regularly assess the work of judges.

In order to be appointed as judge of a court of higher instance, in addition to the referred requirements, candidates must have expert knowledge and ability to fill the position of a judge determined by evaluation of fulfillment of judicial obligations.

In the field of education of judges the central role has the Judicial Academy.

COMMERCIAL COURTS IN CROTIA - IN GENERAL

The first commercial courts in Croatia were established in 1876. After several changes in the past, their present organization generally exists last 57 years.

All commercial courts are hierarchical and are organized in two instances. At first instance there are 7 commercial courts. There is one High Commercial Court of the Republic of Croatia established for the whole territory of the Republic of Croatia, with its seats in Zagreb.

The commercial courts play a very important role in the Republic of Croatia. It is necessary to ensure the rule of law, but it is also one of the important factors within the economic system. One should note in this context that the value of cases in front of commercial courts reach into tens of billions of Kunas on an overall basis. The effectiveness of the commercial courts is thus directly related with the competitiveness and the development of the Croatian economy. Its efficient functioning is also necessary in order to attract foreign and domestic investment.

The particular relevance of commercial courts in the Republic of Croatia was pointed out not only by the leading figures in Croatian politics, science and economy, but also by the high representatives of the European Union and the World Bank.

The need for specialized commercial courts is basically the need for judges who have specialized knowledge and training for commercial cases because of specific nature of the material they are dealing with.

The legal position of commercial courts should make it possible for them to specialize in legal areas important to the functioning of economic entities. It should primarily be reflected in the quality of their decisions, and also contribute to effective legal protection. That should create of a good business environment which encourages economic investment .This demands continuous adaptation to new legal solutions and rapid development of case law in commercial relations.

This adaptation is not only in the content of material law standards, which are applied, but also in the manner in which this is done and methods of interpretation, procedures etc. This also means a huge inflow of new information and sometimes a change in the approach to the application of law.

Croatia has established a commercial mediation program. Commercial courts were among the first in Croatia to begin dealing with mediation, already in 2006. The High Commercial Court is charged with mediation in appeal procedures.

FIRST INSTANCE COMMERCIAL COURTS

Generally, the commercial courts are competent in disputes between legal persons, bankruptcy proceedings intellectual property disputes, register of companies, maritime and air law disputes, status of companies, unfair market competition, monopolistic agreements and pursue other activities provided for by law.

New economic relationships have also given new significance to the court register. Data from this register are available to the public and in electronic form.

Or more detail, Commercial courts in civil disputes in the first instance adjudicate:

1. in disputes between legal persons, between legal persons and craftsman, and between craftsmen in disputes rising from theirs commercial activities;
2. disputes arising from the foundation, work and termination of companies and the disposal of membership and membership rights in companies;
3. disputes between members of companies themselves and between members of a company and the company related to the management of the company and the running of the company's business and the rights and obligations of members of the company arising from their position in the company, disputes between the president and members of the management board or supervisory board of the company and the company or its members which arise in relation to their work in the company or for the company;
4. disputes about the liability of members of a company, a member of the management board or supervisory board of a company for the liabilities of the company;
5. disputes in which the party is a person in respect of which bankruptcy proceedings have been opened, regardless of the character of the other party and the time of the institution of the dispute and all disputes arising from bankruptcy, if for individual types of dispute the law does not specifically prescribe that courts of another type always have subject matter jurisdiction;
6. in disputes relating to ships and navigation on the sea and inland waterways and in disputes to which navigation law is applied (navigational disputes) apart from disputes over passenger transport;
7. in disputes relating to airplanes and disputes to which air navigation law is applied, apart from disputes over passenger transport;
8. in disputes related to the protection and use of industrial property, copyright and related rights and other intellectual property rights, for the protection and use of inventions and technical advances and trade name, if this is not regulated differently by a separate law;
9. in disputes arising from the acts of unfair market competition, monopolistic agreements and disruption of equality on the single market of the Republic of Croatia.

Commercial courts have a broad jurisdiction in non-litigation (non-contentious) procedures in which they shall:

1. act in matters regarding registration and keep court registers,
2. decide on the registration of vessels in the shipping register and on the registration of rights related to these vessels, the limitation of liability of shipping operators, appeals

concerning the allocation of liability in shipping disasters, unless otherwise provided for by law in individual types of cases,

3. decide on motions related to the incorporation, operation and winding-up of companies,
4. decide in non-contentious matters determined in the Companies Act,
5. decide and enforce decisions delivered in the first instance, as well as disputes which arise in the course of the enforcement of these decisions. They may delegate the execution of non-pecuniary means of the execution debtor to municipal courts,
6. conduct proceedings for the recognition and enforcement of foreign judicial decisions and arbitral awards in commercial cases,
7. provide evidence related to proceedings falling within their jurisdiction,
8. decide on safeguard measures in cases in which they have jurisdiction,
9. decide on motions to initiate bankruptcy proceedings and conduct bankruptcy proceedings,
10. carry out tasks relating to international judicial assistance in presenting evidence in commercial cases,
11. pursue other activities provided for by law.

THE HIGH COMMERCIAL COURT OF THE REPUBLIC OF CROATIA

In one word, the High Commercial Court of the Republic of Croatia is appeal court that decides upon the appeals to the first instance commercial courts decisions, the conflict of jurisdiction between courts of first instance and performs other procedures specified by law. As a rule, The High Commercial Court makes decisions in a panel of three judges.

Against particular decisions of the High Commercial Court in which, as a rule, the amount exceed about 68.000,00 Euro, parties may bring a revision as a specific exceptional remedy upon which decides the Supreme Court of the Republic of Croatia.

At their meetings, judicial departments of the High Commercial Court of the Republic of Croatia, shall discuss issues of common interest for the inferior courts in their respective territories.

Legal interpretation adopted at the meeting of the judicial department of the High Commercial Court of the Republic of Croatia shall be binding for all second-instance panels of judges and individual judges of the same department.

LAWS APPLIED BY COMMERCIAL COURTS

As to the law that commercial courts apply in the proceedings, there should be pointed out the Civil Obligations Act, the Companies Act, and the Bankruptcy Act.

The Companies Act regulates the questions of the status of companies, such as the establishment of an enterprise, the nature of its business, its headquarters, its own internal regulations etc. It also regulates the issues of partnership, limited partnership, joint stock companies, limited liability companies, economic interest groupings and silent partnerships. These companies in Croatia possess the same features as in other legal systems, which make them comparable to those in other countries .Croatian Companies Act is based on German model.

However, this law does not regulate commercial contracts. In Croatia, this area is regulated by the Civil Obligations Act which origins are from Swiss Obligatory Law.

The Bankruptcy Act addresses the liquidation and reorganization of a debtor and it is consistent with market-based economy and it is based on German model. Croatian legislation is aligned with law of the European Union (acquis communautaire).

HOW TO SET UP A COMPANY IN CROATIA

Foreign investment in Croatia is widely encouraged. The laws are the same for Croatian investors as for foreign investors and there is no discriminatory treatment. Croatia successfully implemented the e-Tvrtka (e-Company) project in all commercial court registers. This system allows through website hitro.hr for the establishment through the Internet within 24 hours of a limited liability company whose original capital is deposited in cash.

Prior to registration of company, founders must choose a company name and verify its uniqueness. This procedure implies inquiring to the Commercial court register which verifies the name and, if it's available, provides it to the founder. For additional information you can use the website: http://sudreg.pravosudje.hr.

The founders must notarize the memorandum of association, or the company charters and the application for Court Registration together with the director's statement of acceptance of the appointment. If there are relevant documents in another language, then the founders must obtain a certified translation into Croatian language. A company must have a legal residence in Croatia.

In order to engage in commercial activities, a company must be registered with the Commercial Court register. Application must contain the notarized documents, which include the amount of capital, the list of owners and shareholders and another list of the members of the board. The company must obtain a Statistical File number from the State Office for Statistics.

The company founders must also incorporate their company with the tax administration office in Croatia. After the registration is complete, the Croatian company is provided a tax identification number.

Within 15 days of incorporation, the company members must register the company with the Croatian Pension Insurance Institute and the Croatian Institute for Health Insurance.

OVERVIEW OF CROATIAN BANKRUPTCY SYSTEM

The Bankruptcy Act addresses the liquidation and reorganization of a debtor and it is consistent with market-based economy.

In particular, the law is far more creditors oriented than the American system and it is similar to the German and Austrian bankruptcy codes.

The bankruptcy procedure shall be instituted in order to jointly satisfy the creditor's claims by the realization of the debtor's assets and their distribution amongst the creditors. During bankruptcy proceedings the reorganization of the debtor may be instituted in order to regulate the debtor's legal status and its relations to its creditors, especially in order to preserve its operations.

The bankruptcy procedure may be instituted against a legal entity as well as against the assets of an individual debtor, who is the sole proprietor or tradesman. Croatia has not yet drafted a consumer bankruptcy law.

The reasons for bankruptcy are insolvency and overdebtness. In general, a debtor shall be considered insolvent if it is not able to pay its monetary obligations during sixty days period. A debtor shall also be considered insolvent if its debts exceed its existing obligations.

Bankruptcy proceedings shall be initiated by a proposal filed by a creditor or the debtor.

A creditor with a legal interest in initiation of the bankruptcy proceedings shall be entitled to submit a proposal for commencing bankruptcy proceedings if it makes the existence of its claim and any of the reasons for initiating the bankruptcy proceedings plausible.

A debtor may propose the opening of a bankruptcy procedure in case of insolvency or overdebtness (if shows that debtor will not be able to pay the existing obligations when they become due). The management is bound to submit a proposal in case of the existence of any of the reasons for bankruptcy.

Most common types of security in real and personal property in business financing are mortgage on the real estate and pledges on shares or on the bank account.

Most loans to business are secured and in banking this is obligatory in many cases.

In bankruptcy proceedings, the real property estate against which secured claims (a separate right) exist may be sold by the bankruptcy judge upon the proposal of the trustee, in accordance with the provisions on enforcement against the real estate. Creditors who have a separate claim (secured creditors) against real estate, fixtures or rights that are inscribed in a public register (land register, register of vessels, intellectual property and similar) have the right to separate satisfaction.

The majority of claims in bankruptcy proceedings are unsecured. The creditors report their claims to the trustee and it shall be considered established if it has not been refuted during the examination hearing.

Creditors can satisfy their claims by the realization of the debtor’s assets and their distribution amongst creditors according to provisions of the Bankruptcy Act.

In Croatia, an insolvent business is liquidated by a judicial proceeding typically commenced by creditors (mostly unsecured). Liquidation of an insolvent debtor is a court supervised proceeding. The trustee who is in charge of liquidation is appointed by a court.

Non judicial liquidation carried out by members of the company as a method of settling accounts and distribution among company members. This is possible only if the debts of the company have been settled, and it is not possible as liquidation of an insolvent business.

The trustee and the debtor are entitled to file a reorganization (bankruptcy) plan. The trustee can be instructed by the creditors to prepare a bankruptcy plan which has to be voted on during hearing. If the plan is accepted by the creditors and the debtor, the bankruptcy judge shall decide whether the bankruptcy plan can be confirmed. By satisfying the creditors in accordance with the bankruptcy plan, the debtor is relieved of the rest of his obligations.

CURRENT PROBLEMS WITHIN THE COMMERCIAL COURTS

It is well known that a justice who is too slow is no justice at all. As the three-time Pulitzer-winning journalist Thomas Friedman would say, globalization is no longer characterized by big eating small, but by fast eating slow.

Therefore it is clear that fast and efficient resolution of unresolved cases should be seen as a key priority within the commercial judiciary, as well as the Croatian legal system as a whole. However, there are still a number of problems in this area.

Statistical data show that, as one of the consequences of the recession, there was a worrying increase of 251% in bankruptcy cases brought in front of commercial courts in the first six months of 2011 with respect to the same period last year, as well as increase in litigation cases. Even though commercial courts were able to resolve about 20% more cases in this period than in the same period last year, the number of unresolved cases in the first-instance commercial courts was increased.

Another consequence of the economic crisis in Croatia is also a large number of companies that have seen their bank accounts blocked. As a result, there is an increased tendency to use courts in order to delay the paying of obligations, even though, in a large number of cases, these obligations are indisputable. It is considered that the non-payment of obligations is the most frequent cause of commercial disputes in Croatia. The number of corporations which do not have an open business account at all is evaluated at around 5000. In the near future, there will begin a process of liquidation of about 14.000 companies that meet the conditions for being liquidated under the law. There will also be tens of thousands of fast bankruptcy procedures concerning insolvent companies that have no assets or assets of negligible value. A wave of bankruptcies has occurred as a serious social problem, which has not only resulted in economic, but it is also certainly important from the point of the workers.

The crucial question is whether fast resolution of unresolved cases that have accumulated over many years is possible within the existing legal and economic framework in Croatia. The answer, unfortunately, must be a negative one.

Croatia ranks near the top among European countries when it comes to the number of judges relative to the overall population, but also when it comes to the number of legal cases relative to the population. As a result, judges in Croatia, including those working in the commercial judiciary, have higher caseloads than most of their European peers. However, this problem cannot be resolved by indefinitely increasing the number of judges, especially at a time when public funding is scarcer.

The only way to render Croatian commercial courts more able to address the growing problems brought about by the economic crisis is to introduce changes within the legal framework. In particular, one needs to reform the systemic laws concerning the judiciary in a way that would allow speeding up and shortening the legal procedures.

Another way to help the Croatian commercial courts is by reinforcing the discipline within the overall economic system, which would then reduce the flow of frivolous and unnecessary cases arriving at commercial courts. We would therefore like to encourage the implementation of the EU Directive that deals with delays in paying obligations within business transactions.

Moreover, it is also necessary to put out of business those companies that are insolvent and that meet the legal requirements for opening bankruptcy procedures or for being removed from court register. The Croatian business community and the overloaded judiciary recognized the need for change.

One of the founders of the European Union, Jean Monnet, once said that people only accept change once they face the need for it, and they only recognize the need for change once a crisis arrives.

Thus, the most important task that stands before us is to recognize the areas that need changing and to propose changes for the better. This can only be done by thinking out of the box and introducing new ideas, free from the existing legal stereotypes.

References

1. THE CONSTITUTION OF THE REPUBLIC OF CROATIA (Official Gazette of the Republic of Croatia, Narodne novine, no. 56/90, 135/97, 113/00, 28/01, 76/10)
2. COURT REGISTER ACT (Official Gazette of the Republic of Croatia, Narodne novine, no. 1/95, 57/96, 1/98, 30/99, 45/99, 54/05, 40/07, 91/10, 90/11)
3. STATE JUDICIARY COUNCIL ACT (Official Gazette of the Republic of Croatia, Narodne novine, no. 116/10, 57/11, 130/11)
4. COMPANIES ACT (Official Gazette of the Republic of Croatia, Narodne novine, no. 111/93, 34/99, 121/99, 52/00, 118/03, 107/07, 146/08, 137/09)
5. COURTS ACT (Official Gazette of the Republic of Croatia, Narodne novine, no. 150/05, 16/07, 113/08, 153/09, 34/10, 116/10, 27/11, 57/11, 130/11)
6. CIVIL OBLIGATIONS ACT (Official Gazette of the Republic of Croatia, Narodne novine, no. 35/05, 41/08, 125/11)
7. JUDICIAL ACADEMY ACT (Official Gazette of the Republic of Croatia, Narodne novine, no. 153/09, 127/10)
8. BANKRUPCTY ACT (Official Gazette of the Republic of Croatia, Narodne novine, no. 44/96, 161/98, 29/99, 129/00, 123/03, 197/03, 187/04, 82/06, 116/10)
9. MEDIATION ACT (Official Gazette of the Republic of Croatia, Narodne novine, no. 63/03, 79/09, 18/11)

University of Zagreb
Faculty of Economics & Business

Trg J. F. Kennedyja 6
10000 Zagreb
CROATIA
Tel: +385 1 2383 333
Fax: +385 1 233 5633
e-mail: hhorak@efzg.hr *;* kdumancic@efzg.hr
http://www.efzg.unizg.hr/JeanMonnetChair